

11-1-2008

Center for Real Estate Quarterly, Volume 2, Number 4

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Center for Real Estate

Quarterly & Urban Development Journal

• *4th Quarter 2008*



- Credit Crisis Shifts Urban Development Paradigms
- Green Building Management & Average Buildings
- Developing The Nines
- Luxury Rentals & Condominiums Revisited
- Housing & Retail Market Analyses
- Office & Industrial Market Analyses
- Will Macht
- David Pogue
- Donald Eggleston
- Greg LeBlanc
- Elizabeth Warren
- Greg LeBlanc



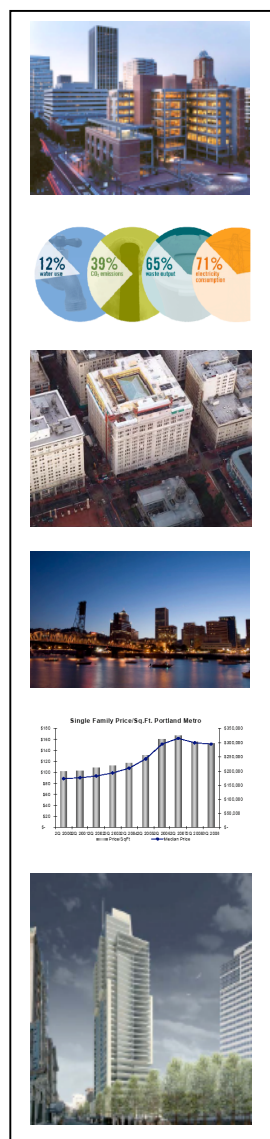
Center for Real Estate

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• 4th Quarter 2008

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Editor's Urban Development Journal:
Shifting Urban Development Paradigms:
Credit Crisis Stimulates Shifts

Professor Will Macht, Editor



In the midst of the worst economic turmoil in the housing and credit sectors since the Great Depression, it is incumbent upon us to ask if we in the development community can use this crisis to shift urban development paradigms to a more sustainable future.

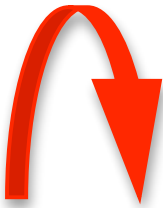
It has become clear that the United States is experiencing a massive deleveraging process. As recently as the 1980s, the U.S. was the largest creditor nation and has moved to become the largest debtor nation in the world. National debt has doubled in less than eight years from five to ten trillion dollars and annual deficits are reaching a half trillion. The financial bailouts and rescue plans of the last month add another trillion. Household debt service has risen to about 20 % of disposable income. The U.S. savings rate has fallen close to zero, its lowest level since the depths of the Great Depression, right at the time the largest cohort of Baby Boomers is starting to retire. And as housing prices decline both nationally and regionally, equity in

housing, the largest single investment of most Americans, has declined precipitously. In short, as former U.S. Comptroller General David Walker has said repeatedly, we are over-extended financially both here and abroad.

What kinds of paradigm shifts are likely in the urban development community as we move through the process of deleveraging? What trends can we perceive and how can we adapt to them positively? Below, I identify ten such shifting paradigms:

1. From Consumption to Investment

It has become clear that as credit has become frozen, housing values have plummeted, equity values have diminished, income growth has decreased and unemployment has increased and savings have been eliminated. Consumption based upon all of these monetary sources has, and must, decrease. Home equity loans declined precipitously with falling equity values, and credit card companies are both lowering credit limits and purging credit risks. Retail sales have declined and the underlying forces suggest they will continue to do so. As businesses experience deeper recession, wholesale sales will also decline.

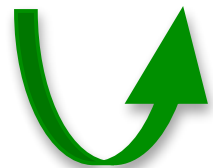


Some have suggested that Portland is ripe for retail expansion of substantial dimensions since it has about 12 to 15 square feet of retail space per person versus approximately 40 square feet of retail space per person in California. I would suggest that is unrealistic, even under normal circumstances, and counter-productive under the extenuated conditions of our current economy. It is much more likely that retail sales and the space needed to produce them, will decrease as consumers retrench and smaller retailers succumb to declining profit margins.

But the problem of overconsumption goes beyond retail sales. As housing unit size has grown over the decades, the furniture, fixtures and equipment it contains have expanded, and spaces in which to store it have also grown thereby fueling massive consumption, a great deal of which has been financed with credit. Single-car garages that were the norm in Portland have blossomed into houses with three- and four-car garages. The cars and SUVs stored in them have increased in size and price, and they too are largely financed with credit. The Great Depression changed a mindset for a generation that resulted in consumer behavior to spend only residual cash resources after first saving. While it may be premature to suggest a similar retrenchment in a nation enmeshed in ubiquitous advertising and instant gratification, the suddenness of the financial shock followed by a prolonged recession is likely to change spending patterns.

Matched with massive private expansion of credit and diminution of savings has been a concomitant massive expansion of public credit. The pay-as-you-go rules in the Congress have been eliminated. The cost of the wars in Iraq and Afghanistan has been financed with credit helping to double the national debt to over \$10 trillion. And even the over one trillion dollars for the \$700 billion Troubled Asset Relief Program (TARP),¹ \$300 billion Fannie Mae and Freddie Mac conservatorship² and the \$85 billion federal loan to AIG are to come from further federal borrowing. State and local debt has expanded and California is even in a position to need \$7 billion, not to finance capital improvements, but rather to pay operating expenses.

How are we going to fix and fund a staggering backlog of under-investment in urban infrastructure and deferred maintenance of roads, bridges, railroads, sewer and water systems and electricity transmission



¹ "Emergency Economic Stabilization Act of 2008," (EESA)

² "[Housing and Economic Recovery Act of 2008](#)" (HERA)

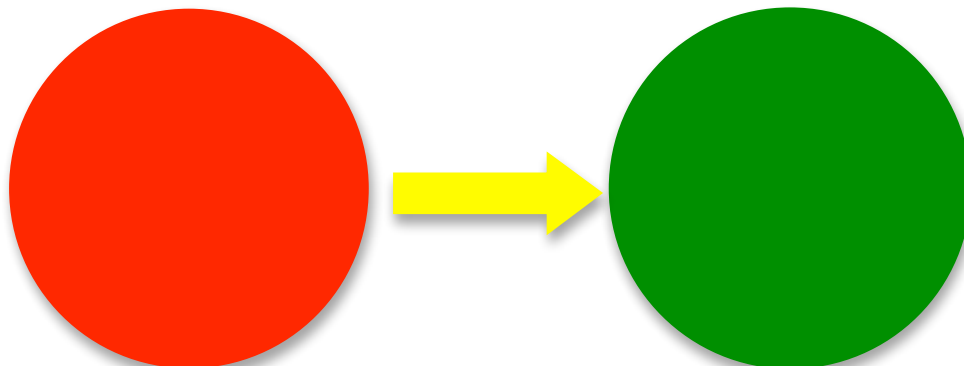
grid? In July 2008, the American Society of Civil Engineers estimated that \$1.6 trillion is needed in the next five years alone for repairing and rebuilding this infrastructure. Not even the collapse of the Minneapolis urban freeway bridge seems to have galvanized a major effort to remedy the problem. Traffic control systems at our airports are antiquated and not a single high-speed inter-city rail corridor exists in what is still the wealthiest country on the planet. Rail stations, like Union Station, are deteriorated, hospital emergency rooms are overcrowded and electricity grids are overloaded even at time when we are beginning to move to a new generation of electric vehicles. Schools are crumbling and universities like Portland State are seriously short of classrooms at the very time we expand from 26,000 to 35,000 students in less than a decade. Where, how and when can we make these investments? How can we use this investment to help build new green technologies?

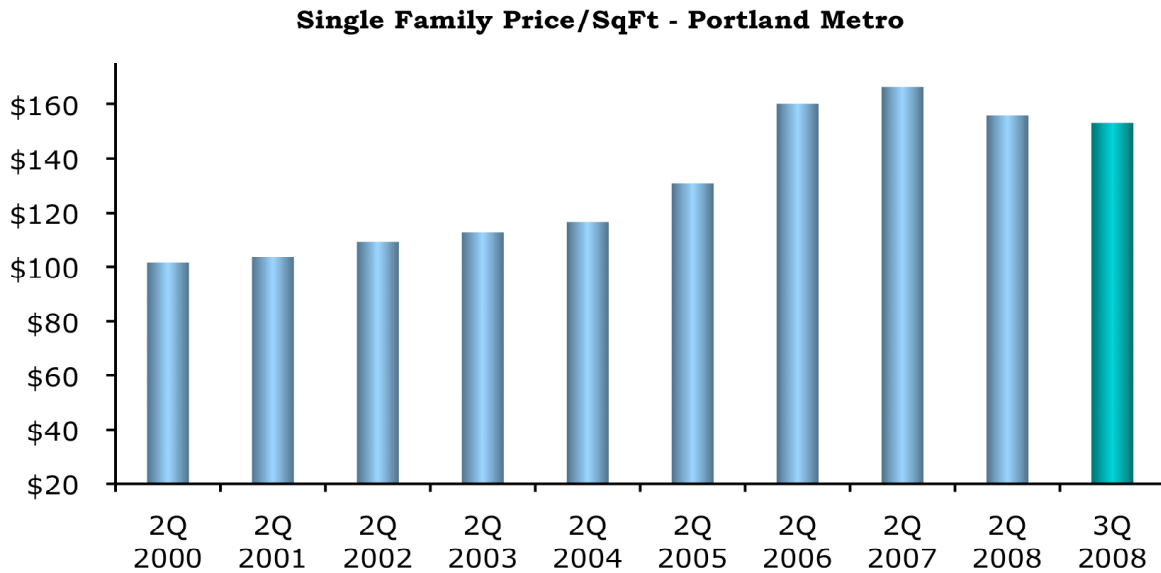
By necessity, any public funds will need to shift from consumption to investment. But so will private funds. It will be necessary to invest in a broad spectrum of green building improvements from sophisticated HVAC control systems, to light-emitting diode [LED] lighting, to energy recovery systems, to energy-efficient, on-demand distributed generation, to geothermal and solar generation equipment under and on new buildings, and to a whole host of innovations yet to be devised. These will be investments that will produce income and/or decrease operating expenses and will take precedence over cosmetic improvements like marble lobbies or granite counters.

2. From Debt to Equity

The net result of the over-reliance on massive debt, both public and private, will lead to a resurgence of the need for equity. One must distinguish between debt for operations and capital debt. The federal government still does not have a capital budget. It desperately needs one. Expenditure for wars in Iraq and Afghanistan consume both labor and materials. These are operating expenses. The \$700 billion for foreign oil that we borrow from Asia, to buy oil from the Middle East, to burn in America are operating expenses. Investments to rebuild the collapsed freeway bridge in Minneapolis are capital investments that will return economic and social benefits for decades to come. The same is true with respect to railroads, airports, schools, water and sewer systems and schools where human capital is created. Federal, state and local capital budgets need to be created that are transparent and accessible to businesses and citizens. They set major priorities that are too often opaque.

But the private development community has also binged on easily available credit. Layer upon layer of debt with high loan-to-value ratios, mezzanine loans from investment bank pools, securitized mortgage pools with ephemeral security and derivative instruments slicing and dicing the pools into tranches of different term, risk and interest levels, credit default swaps to “insure” essentially insecure paper with inadequate reserves—have all helped to inflate development values and have driven down capitalization rates to historic lows. The fee-driven pursuit of maximum credit in housing markets has driven housing values to clearly unsustainable levels that are now exploding.





But as the chart above shows, as is detailed in our housing review article in this issue, Portland housing prices are still above those as recent as 2005, and about 50% above those in the year 2000 when the housing bubble began to replace investment fleeing from the collapse of the technology bubble.

Historically, purchasers of both housing and commercial properties had to invest substantial sums of equity in buildings in order to provide long-term lenders with a comfortable cushion in the case of default and foreclosure. But with the sophistication and securitization of real estate credit markets, lenders did not hold the mortgage paper and were no longer responsible to ensure that income was sufficient to service the debt. Moreover, as housing values ballooned and capitalization rates fell, inflated property values artificially increased the supposed equity cushion. And since the mortgage originators and each of the securities' packagers collected fees at each step of the process, each had an economic interest in increasing credit and inflating values.

It is now clear that financing development with excessive credit will no longer be possible, even if it were thought by some to be desirable. So it is axiomatic that if projects cannot be financed with much credit, they must be financed with equity. In housing, that must come from increased levels of saving, which will be difficult in a period of stagnating wage growth and increasing unemployment.

On the commercial side of the development community, in the later years of the last decade there has been considerable growth in private real estate equity funds. Many were started by the investment banks, which in turn have morphed into commercial banks during the current credit crisis. These funds have fueled a great deal of development. But like their hedge fund counterparts, they have high investment thresholds, bear stiff fees and short-term investment horizons. Their share of the profit is typically 20% referred to as the "promote" or "carried interest". You may recall the controversy about this "carried interest" being taxed as capital gains at only the 15% rate rather than the 35% rate. Often with target rates of 20% IRR (internal rate of return) and a preferred annual return of about 10%, with expectations of doubling the value of the equity over the life of the investment. These investments are still relatively short-term from about two to no longer than seven years. So, one can conclude that this is very expensive equity capital that is only likely to be sustainable during a period of rapidly inflating property values.

Equity Real Estate Investment Trusts (REITs) may be an important source for larger projects, but local longer-term equity pools will likely be needed in the Portland metropolitan area. Unlike their mortgage REIT counterparts, in the first nine months of 2008, the equity REITs generated total returns, including dividends, of about 1.8%, according to the National Association of Real Estate Investment Trusts, while the Standard & Poor's 500 stock index was down 19.3%. A potentially bad omen may be that companies posting the biggest gains were self-storage REITs, which generated returns of 33.8%, perhaps as a result of storage caused by foreclosures.

As a result, it is likely that the development community must return to a period when far greater proportions of an investment are derived from long-term equity based upon reasonable annual cash flows and slowly appreciating values. Contrary to the experience of those who entered into real estate in recent times, there was a time when great wealth was created in precisely this way.

3. From Short-Term to Long-Term

For the past few decades, America has been fixated by the short term. Stock market reports focus on earnings for the quarter and values can rise or fall on whether companies meet analysts' estimated targets. Executive compensation is pegged to such performance. Along with the rise of REITs in the public market, followed by the securitization of mortgages and derivatives of them, short-term performance has overtaken the real estate industry.

Discounted cash flow analysis also favors the shorter term. The earlier a dollar is generated or saved, the more it is worth in the analysis. Why spend more capital on longer-lived materials when the delay of replacement costs is of marginal relevance to near-term results? Why sign a five-year lease at a lower rent when you can sign a three-year lease at a higher rent? Why pay to move a tenant to accommodate expansion of a long-term tenant if you will probably not own the building for the longer term? Why install sophisticated HVAC systems if the cost recovery period is longer than your building holding period?

Exacerbating this attention to the short term is the improvement in real estate software that spits out seemingly definitive hard numbers on a month-to-month basis that give apparent credence to your projections? So the thinking goes something like this: Add to your planning the difficulty of projecting over the longer term along with articulating the assumptions upon which all of the numbers are based. Factor in a lower interest rate with a longer amortization period but a shorter balloon payment. Your numbers convince you and your investors. How does one quantify risk anyway? Property values will continue to climb and the rising tide will take care of any of your mistakes. The lesson students and practitioners of real estate too often learn is plan short, build cheaply and sell quickly.



There was a time when visionary developers thought in terms of quarter centuries, not three-month quarters. When John D. Rockefeller, Jr. built Rockefeller Center, it was to hold, not to be sold. The great real estate fortunes of John Jacob Astor, Henry Huntington and Henry Flagler, the Durst, Shorenstein and Ashforth families, and many others, were built on the premise of building for the long term. Such a family will be very concerned about building using solid materials and quality systems that have longer lives and lower operating expenses. They will do everything possible to keep long-term tenants even if they must pay to move others to accommodate a long-term tenant's expansion.

But a merchant developer, who will flip a building upon completion, if not before, will not absorb short-term pain for long-term gain that would accrue to future owners. And as residential markets have been overtaken by condominiums, where the developer, who

enjoys none of the savings in energy operating expenses, but rather sells upon completion, will spend little time and money on building well unless there is a short-term premium upon sale. With a glut of condominiums on the market as a result the national binge on short-term credit, that is very unlikely to happen anytime soon.

Unfortunately, build and hold has been a strategy too few developers have been either willing or able to follow. In Portland, which until recently has been less in demand by national real estate investors, there are still some developers, like Joe Weston and the Schnitzer and Schlesinger families, invested long-term. Portland views itself as the green building capital of America. If the business of development is the creation of value, which it is, then green building creates long-term values, especially as energy prices rise. And with those rising energy prices, buildings that are not green will become functionally obsolescent, analogous to the way that energy-consumptive sports utility vehicles (SUVs) have witnessed values that have depreciated twice as quickly as in previous years. So the risks of not building green will rise. And as property values cease their seemingly inexorable rise of the past decade fueled by cheap credit, easy terms and falling capitalization rates, those developers who build quality buildings they plan to own for decades should help real estate once again become a long-term asset class with lower but stable cash flows that slowly but steadily appreciates.

4. From Deregulation to Reregulation

For the past three decades, the mantra in both federal and state capitals has been deregulation, and its ideological cousin, privatization. The housing and credit debacle has made clear that the privatization of profit and the socialization of risk is neither economically nor politically acceptable any longer. The cruel irony is that it is the federal administration that most championed free market fundamentalism that is the architect of its decline. Turning a half trillion dollar surplus to a half trillion annual deficit, and doubling the national debt to \$10 trillion, at the same time as it spends another trillion to buy bank equities and non-performing mortgages, must surely be a legacy no free marketeer would prize. The price of fiscal imprudence will be reregulation.



The scope of that reregulation will take shape in the next administration no matter which party controls it. It will no longer be acceptable to issue loans, guarantees, credit default swaps and insurance without adequate reserves. Comprehensive control of non-depository institutions will take shape. Disclosure requirements will increase transparency.

And even without reregulation, the mere fact of consolidation of the banking and mortgage industry will decrease competition. Thousands of employees will lose their jobs and hundreds of bank branches will be closed. It will be a good time for developers to plan for the conversion of empty bank branches the way they did for vacated gas stations as the oil business was consolidated. The beneficial difference is that toxic mortgages do not remain in underground tanks the way that hazardous chemicals do. The banking consolidation alone will make all of them too big to fail, which will entail comprehensive and detailed regulation. That should stimulate the conversion of some private office buildings to public regulatory headquarters at least in financial capitals.

An important lesson of this housing, mortgage and credit crisis is that ideology can blind policy makers from pragmatic solutions. Neither the government nor the private sector is either the problem or the solution to most issues. Abuses of power and conflicts of interest occur in both sectors. Adamant against acquiring equity interests, the federal government acquired an 80% interest in AIG and is in the process of acquiring \$250 billion of bank

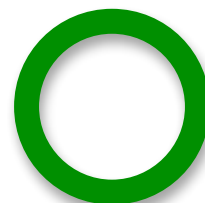
preferred stock as well as guaranteeing interbank loans. Led by the British, the decision by the European Community to buy equity and guarantee interbank loans left the U.S. no choice but to do the same to prevent American depositors from moving massive capital to European banks.

Students of American history know that our economic system has been both regulated and mixed from its very earliest days. The very first Secretary of the Treasury, Alexander Hamilton, created the Bank of the United States to use sovereign powers to regulate credit, to fund the national debt and to assume state debt. He was also the chief proponent for the use of federal power to build and regulate both physical and fiscal infrastructure. In designing the new regulatory framework, we must be careful to focus on what works, not on what is ideologically pure.

Ideology also led to the proposal of only one alternative during the bailout consideration—the acquisition of toxic mortgages. Exacerbating that is that technique appears to be one of the most complicated and requires the outsourcing to Wall Street asset managers, whose expertise created the problem, to acquire at an unknown value the toxic mortgages they or their colleagues had a hand in creating. This was supposed to be done through reverse auctions by banks offering to sell pools of assets to a single buyer. This method and its problems are complicated³ and are likely to lead to both liquidity and solvency problems, even if several banks own the same mortgage-backed security. If not, reverse auctions are impossible and over-valuation and payment by Treasury for toxic assets is likely.

Direct purchase of equity is simpler and can be more effective. But even then, the Treasury agreed to accept 5% dividends on its preferred stock at the same time as Warren Buffett negotiated 10% for preferred equity at Goldman Sachs. Nor is there any requirement that the bank not pay other dividends, which have been projected to be as much as \$25 billion of the \$125 billion federal investment. Those dividends would deplete bank capital replenished by federal investment and enrich existing shareholders, many of whom would be the very executives who depleted reserves in the first place. And the new preferred equity issued bears no voting rights, no requirement to lend proceeds or to cap executive compensation beyond inability to deduct more than \$500,000 from corporate taxes or issue new golden parachutes.

One wonders why a much more transparent and effective technique would have been to directly buy new public issues of preferred stock, convertible into common stock in order to set a market price, with full voting rights that would be exercised to ensure lending of proceeds along with compensation caps. Moreover, these new preferred stocks would be sold to the market too, so that government purchases would encourage private capital to add to government investment. The mere fact that Treasury would be buying massive amounts should bid up the price enough to attract private capital and therefore it would leverage the Treasury's investment's positive effects for bank recapitalization, without unjustly rewarding existing shareholders. After credit markets are well stabilized, the Treasury could slowly divest at a profit since its sales would be into a market that would have a transparent market value. It appears that free market fundamentalism precluded this kind of pragmatic technique.



Another technique goes to the heart of the mortgage performance problem would require essentially no public capital. The Congress would enact a statute that encourages homeowners with impaired mortgages to forfeit their deeds in lieu of foreclosure to their lenders but allow them to stay in their homes for five years, paying prevailing market rent.

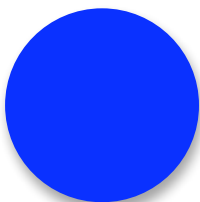
³ <http://www.portfolio.com/news-markets/top-5/2008/10/08/How-TARP-Bailout-Can-Work>

Under the statute, the lender would be forced to accept the deed, and the rent. After five years, the homeowner-turned-renter would have the right of first refusal to buy the home back from the lender at fair market value.

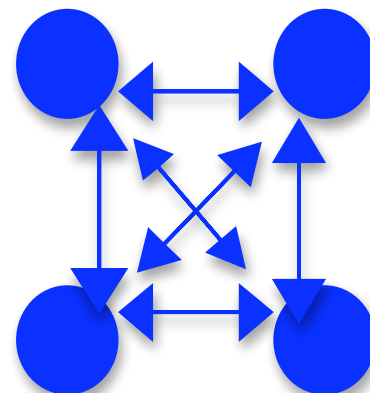
This plan requires no federal money, does not let either the borrower or lender off the hook and avoids foreclosure price depression from a massive vacation of houses foreclosed or about to be. The borrower loses the deed, at least temporarily, but gets to stay in the house at a considerably lower cost and repurchase it at its true value. The lender loses the full amount of the debt service payments for five years, but has the possibility to recover some or all of it if the market recovers in that period. It need incur no additional costs in holding and selling the property through foreclosure. And the city retains the tax revenue. The details of such a plan cited below⁴ clarify such details as fair market rents, recovery lease terms, transferability and termination.

5. From Projects to Networks

We can no longer afford to undertake projects that do not add to urban networks. In the last two issues of this journal,⁵ I have written extensively about the importance of building overlapping urban networks and how to evaluate whether a project adds to an urban network or sits apart from it. For example, I showed how Beaverton Round is isolated from its surroundings and must reproduce everything on its site to make it work—structured parking, street amenities, mixtures of uses, recreation and a poor semblance of a place for housing. It is not only very expensive, but cannot build on an existing urban fabric because it sits in a suburban field isolated and disconnected, despite the fact that a large-scale retail center, Cedar Crossing, and other suburban uses exist in less than a mile.



Conversely, growth corridors like NW 23rd Avenue, Hawthorne, Belmont, East Burnside and Alberta Streets have grown organically, building-by-building, restaurant-by-restaurant, shop-by-shop to reinforce one another. I pointed out that the city even provides free surface on-street parking at a ratio of 2 spaces per thousand square feet of retail space just because the projects are built along a street. Frequent bus transit improves accessibility as a by-product of its normal routes and the streets are bicycle-friendly as anyone witnessing the large quantities of bikes parked along the street and special bicycle pens can plainly see.



I showed how the \$4.2 billion, 12-lane Columbia River Crossing project advocated by the Oregon and Washington transportation departments does not address the genesis of the congestion—the fact that four arterial highways on each side of the River must converge at a single point to cross the River. With three through lanes on the bridge, to match the lane configuration north and south, the DOTs' solution cannot solve the underlying problem. Bandwidth of the bridge is not the issue—location is the problem. So the \$4.2 billion bridge is not only unaffordable after the national economic crisis, it does nothing to add to the urban network linking various arterials, providing alternative routes and dispersing congestion. The cruel irony is that the alternative of a twin road/rail bridge to the existing rail bridge, coupled with raising the I-5 Bridge by only 18 feet, eliminating the lift span and adding two center reversible lanes in its place, is a far

⁴ http://www.westwoodcapital.com/opinion/images/stories/articles_oct/the_freedom_recovery_plan.pdf

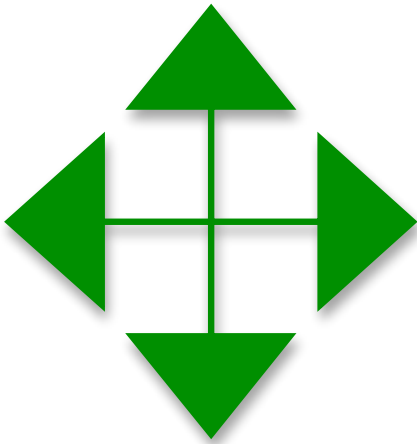
⁵ http://www.pdx.edu/media/r/e/RE_3Q08.pdf ; http://www.pdx.edu/media/r/e/RE_2008quarterly.pdf

less expensive alternative that does far more. A silver lining to this economic cloud may be that the \$4.2 billion behemoth bridge plan may sink by reason of its own bloated budget.

6. From Subsidies to Joint Development

For too long, public development agencies have socialized risks and privatized profits in development projects. They have aggregated land at fair market value and written down its cost by selling to private developers at subsidized prices below market value. The result is that the land is sold at the lowest value in the development cycle, and the profits created by the increased land value by reason of the development that will occur on the land accrue wholly to the private developers and building purchasers.

A far better solution for public development agencies is to retain the land it aggregates and to ground lease it in small pieces to individual developers. This works for both parties. The developer no longer needs to finance the land and can deduct the ground rent from its taxes, while it is unable to do so for purchased land. And the public development agency earns an income stream that increases with the increased land value occasioned by the urban development it has made possible. Removing the land cost upfront for the developer removes the monkey of land carrying costs and land property taxes from his back that impels developers to build less densely early in the process because that is all the market can absorb at that time. Rather, the developer can build more densely at optimal times to reap greatest profits. And the public development agency will reap not only rising ground rents from greater land values, but also the increased tax revenues because the project is built more densely.



The simple fact is that governments no longer have enough resources to subsidize development. The federal government has a half trillion annual deficit at a minimum and a \$10 trillion outstanding national debt. Oregon faces a \$2 billion deficit over the biennium. The City of Vancouver faces a \$6 million deficit and the City of Portland appears to face substantial shortfalls. Yet Metro still considers subsidies to develop a headquarters hotel for the Oregon Convention Center, while Portland entertains rebuilding PGE Park and a new baseball stadium. Governments can no longer afford to subsidize such

low-return projects. Cities like Vancouver weigh whether to purchase a \$30 million, 118,000 new former headquarters building for the Columbian newspaper that was too expensive for it to retain. At least there, an argument can be made that consolidation of leased space into a newly owned building might be beneficial for the long-term. But is it in fact a subsidy to keep the Columbian from declaring bankruptcy?

Following the credit crisis, local governments will need to enter into joint developments in which they can directly benefit, economically, from the success of the development. In the process, they can generate long-term income streams that can supplement or replace tax revenues. They are the longest-term investors and should benefit not only from a growing income stream but also from increasing equity values. Local governments need hard-headed, sophisticated development managers who can put joint development deals together that reward the public sector, as well as the private sector. Private affluence and public penury will no longer be acceptable. The tasks of rebuilding our communities, from infrastructure to growth centers and corridors to neighborhoods are too difficult and too

important to leave to one sector. The public sector should become a joint developer, thereby properly compensating public risk-taking.

7. From Zoning to Mixing

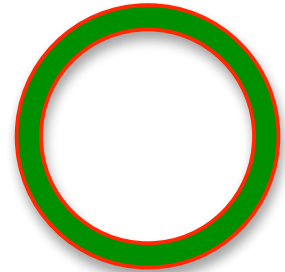
Less than a century after it adopted its first zoning ordinance in 1924, Portland should have learned that zoning for single uses wastes land, requires commuting, congests traffic, multiplies parking demand, precludes shared parking and segregates communities by age, income, education, household size and, until recently, by race and ethnicity.



In an era of especially scarce resources of land, transportation and capital, we can no longer afford to do that. The credit crisis, reinforcing the energy crisis, should be enough to shock decision-makers to transform planning from zoning to mixing uses—from separation to combination.

The enormous increase in housing foreclosures will help to decimate neighborhoods. Those single-use suburbs that are too distant and without a mixture of services will suffer sharp declines in values. This is an obvious problem for former homeowners and struggling lenders. But communities can use the housing crisis as an opportunity to transform the underlying problem. Foreclosures will result in tax delinquencies that put cities in ownership of large numbers of properties. Cities should aggregate those properties into a land and housing bank that can be planned for more intensive mixed uses. Cities can retain ownership of the land and sell the houses much in the manner of the Community Land Trusts. Cities can reduce sales prices to increase affordability but be repaid by inclusion of shared equity provisions upon later resale of the houses when the market recovers. The addition of services will also enrich the neighborhood, both economically and socially.

Cities can also use the foreclosures to advance rational annexation to reduce the costs of providing public services. During the Great Depression, cities like Saskatoon retained the foreclosed properties it had acquired to form a Saskatoon Land Bank. Not only did the bank foster more rational planning, it also helps fund affordable housing.



The land use patterns of single-use zoning are simply no longer sustainable economically, raising the price of land for developers, extending roads and sewers that the public can no longer afford to develop or properly maintain, and raising the costs of transportation energy consumption and air pollution. Single-use zoning creates places without services that fewer buyers will either choose or be able to afford. In a word, single-use zoning is no longer sustainable, economically or ecologically.

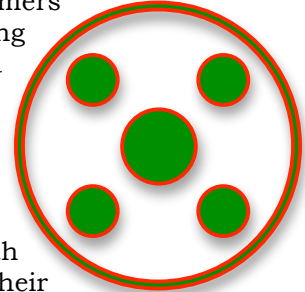
8. From Edges to Centers

Lacking adequate public or private capital to develop infrastructure at the edges, and no longer able to afford the energy or atmosphere to support long-range commuting, we are likely to witness stagnation at the edges and movement towards the centers of our communities. By this I do not mean simply a central downtown but rather a plethora of new urban growth centers and growth corridors that contain facilities able to support jobs, housing, services, entertainment, recreation and culture.

In an era of scarce resources, made substantially scarcer by the decimation of housing markets, the multiple bankruptcies of homebuilders and banks, and the diminished tax revenues that follow declining markets, places at the edges of urban growth boundaries will

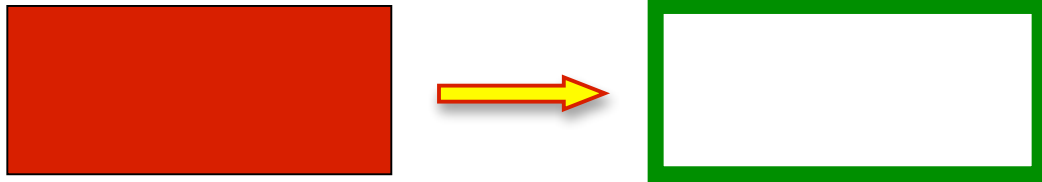
not be able to generate either public or private funds to build the infrastructure to maintain them. In a very important way, the bitter battles that have been fought at the urban growth boundaries' edges were, and are, simply the wrong battles to have been fighting. We have been fighting the last wars of the sixties and seventies when we should have been planning the strategies for more intensive growth within the cities for the 21st Century. The Big Look being undertaken in Oregon has not been big enough. How are we going to be able to form livable mixed-use centers and corridors within the cities, not new suburbs at the edges?

The two largest cohorts making housing decisions are the Baby Boomers and their children, the Echo Boomers. In increasing numbers, aging Baby Boomers have been choosing to vacate the suburbs to live a more diverse life in the cities. And the Echo Boomers, who grew up in the suburbs, are increasingly choosing to migrate to the cities. If you look at the data that we have been charting in this issue and previous issues of the journal, you will see that the close-in locations have preserved their housing values much better than the suburbs, which have suffered enormous losses. People are voting with their feet and their wallets. Developers and planners need to shift their attention to intensifying and improving existing growth corridors and growth centers.



9. From Retailing to E-Tailing

It should be no surprise that retail sales have fallen sharply as a result of the housing and credit crisis. Americans have been using their home equity loans as ATM machines to consume vast quantities of retail goods. The decimation of consumers' home equity closes the bank windows. Along with that, as credit card losses mount, banks are reducing credit lines, charging new fees, shortening grace periods and terminating many borrowers.

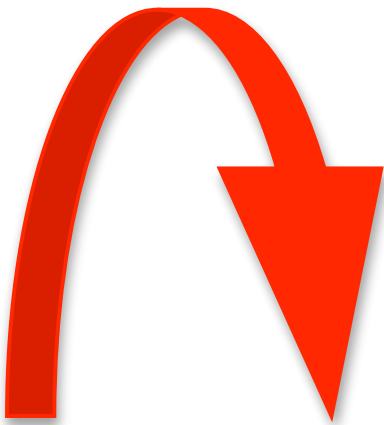


As consumption stagnates and shifts to investment, retailing will shift to the lowest-cost providers of goods. For a whole array of reasons, these lowest-cost providers will be e-tailers rather than retailers:

- Rents for retail space are roughly quadruple those for distribution warehouse space.
- Etail operating hours are double those of retailers; websites that are always open.
- Retailer market areas rarely exceed 10 miles; etailers operate worldwide.
- Retail stores rarely reach a million shoppers, whereas etailers can reach billions.
- Computer-owner online buyers are more affluent than average retail customers.
- Advertising per shopper is far more expensive for retailers than etailers.
- Selection of SKU items can easily be 10 times as great for etailers than retailers.
- Comparison shopping is easier online than at multiple stores.
- Traffic congestion and parking inhibit retailers' sales, not etailers'.
- Most retail sales incur sales taxes; most etail sales do not.

- Retailers suffer shoplifting losses; etailers do not.
- More manufacturers can sell direct online but most retailers are middlemen.
- Changing prices is expensive for retailers, but marginal for etailers.
- Auction pricing is easy for etailers; it is rare and difficult for retailers.
- Sales volumes can be higher for etailers than retailers.
- Retailer sales are labor intensive while etailer sales are automated.
- Operating expenses are higher for retailers than etailers.
- Product information is more ubiquitous online than from retail salespeople.
- Location is critical for retailers but insignificant for etailers.

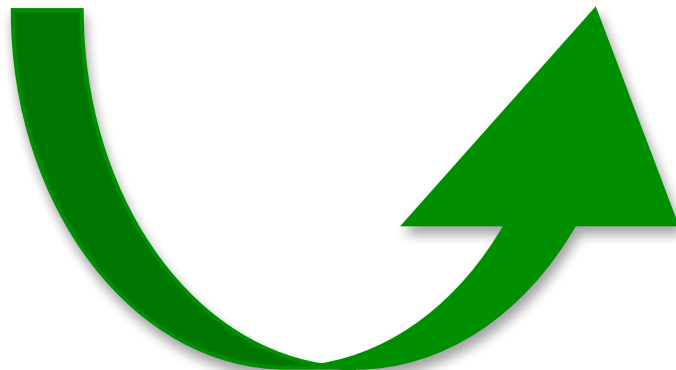
As consumers are forced to buy less with lower credit available and stagnating incomes, etailers will capture increasing retail sales. The result will be substantially reduced retail space developed, if at all, at the same time as negative net absorption will likely result as retail space is removed from the inventory. Forrester Research reports that 2008 online retail sales will grow 17% in 2008 to \$204 billion. At \$300 per square foot average sales, that equates to over 680 million square feet of retail space. The roughly 50,000 American shopping centers aggregate about 6 billion square feet of leasable space. So rapidly growing online sales, at the same time as rising retail vacancies in malls, shows the growing impact of the trends.



10. From Commuting to Telecommuting

The increased cost of commuting, both in dollars and time, will lead to much more widespread telecommuting. It is far less expensive to move electrons than people. Moreover, rising layoffs and unemployment will dump large numbers of service employees and others with a variety of skill sets into the labor market with too few employers to absorb them. In addition, the rise of child-bearing among the Echo Boomer cohort will create incentives for women especially, who have previously been in the labor force, to choose to start, or work, at businesses that permit them to work at home.

It is estimated that approximately 14 million workers now telecommute. If the average office and circulation space occupied by workers is 200 square feet, that equals 2.8 billion square feet of office space. While many workers both telecommute and commute, the total office space equivalent is still very sub-



stantial and growing and will have an adverse impact on new demand for development of office space. On the other hand, broadened telecommuting would reduce traffic congestion, gasoline consumption, foreign oil imports and greenhouse gas emissions. And increased numbers of virtual offices could increase residential home office construction and help absorb excess home inventories placed on the market by virtue of home foreclosures.

It is clear that the housing and credit crises will have enormous impacts on our economy, both national and local. For some, its effects are already devastating. Pacific Lifestyle Homes is the fourth major Portland-area builder to file for bankruptcy reorganization. Earlier this year, Marnella Homes, Legend Homes and Renaissance Homes also filed for Chapter 11 bankruptcy.



We must use these cataclysmic events to recognize the major shifts in urban development paradigms that are likely to occur. We must use our knowledge and creativity not only to adapt to these shifting paradigms, but also to channel these dislocations to improve our development community and to channel its resources towards making these shifts improve our broader community and our lives.

Respectfully yours,

William P. Macht

Professor Will Macht
Editor, Center for Real Estate Quarterly
Associate Director, Center for Real Estate

I want to especially acknowledge the financial contributions for this journal from the Oregon Association of Realtors and the RMLS.



In addition, we greatly appreciate the assistance of each of the following in the preparation of this journal:

- CB Richard Ellis
- Cushman Wakefield
- Gerding-Edlen Development
- Grubb & Ellis
- Metro
- Norris Beggs & Simpson
- PGP Valuation
- TMT Development
- Willamette Valley MLS
- Realty Trust
- State of Oregon
- SERA Architects



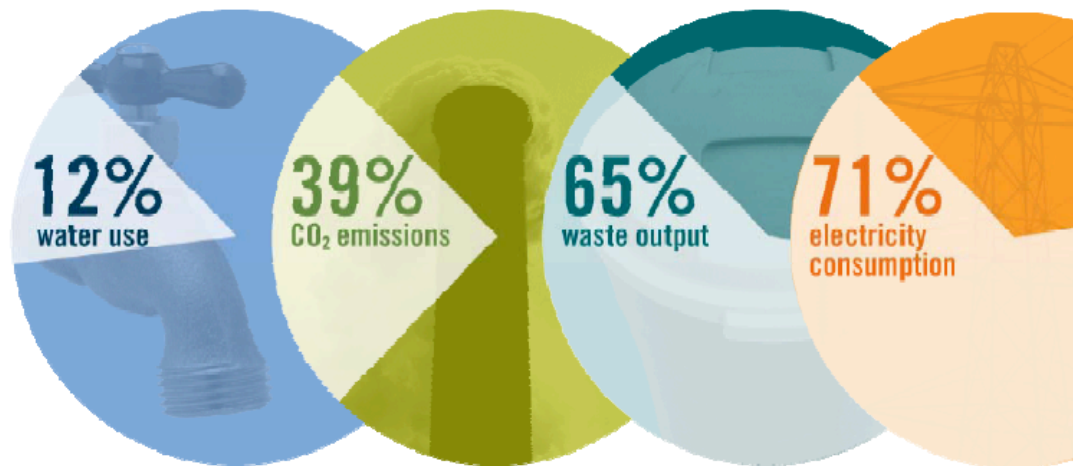
Green Building, Operation & Management: Improvements of Average Buildings Can Outperform LEED Stars

David Pogue, National Director of Sustainability, CB Richard Ellis

The general topics of sustainability and environmental stewardship have been in the popular press for some time now. The debate surrounding climate change and the growing impact of steadily rising levels of CO₂ and other green house gases (GHG) is becoming more focused not on whether the matter is true, but on what we can and should do to take responsible actions to reduce and mitigate emissions. It has been widely reported and accepted that the building industry, and specifically commercial office buildings, play a significant role in this issue. The United States Green Building Council (USGBC) estimates that office buildings use more than 70% of all electricity in the United States and contribute nearly 40% of all GHG. Offices buildings in the United States, in fact, produce more GHG than any single country produces from all of its activities combined. The building industry also consumes more than 12% of all water used and produces 65% of all waste.

Corporate Buildings

United States



Taken together these are not sustainable practices and clearly the office building industry can and should be a focus of improvement in our overall efforts to finding solutions to the growing crisis. Concentration on improvements to the vast majority of average buildings in the major areas of electricity consumption and waste generation can have the largest impacts. But almost exclusive attention to a small number of award-winning high-profile projects at the end of the bell curve has obscured the potential for major savings in the middle of the curve.

This growing focus on the role that buildings play in the overall sustainability movement comes at the same time that more and more companies and businesses are beginning to focus their own internal practices and programs on this topic. More and more companies are reporting on the so-called “triple bottom line”, which means economy, ecology and equity, and are including their sustainability efforts in their annual reports. Companies are facing increasing pressure from shareholders, employees and customers to demonstrate their commitment to

sustainability. And whether a company is attempting to measure and reduce its own carbon footprint, demonstrating its sustainability credentials to attract and retain new employees, or merely trying to utilize conservation as a method of cost containment in a difficult business environment, the choice of office space has an important impact.

And if that were not enough pressure from building tenants, institutional owners of commercial real estate assets also now face similar and growing pressures from their clients and investors about the sustainability standards of the assets they own. Seemingly, everyone is beginning to focus on this business segment and all of this attention is beginning to impact the real estate industry.

So what exactly is a green building? How do you measure sustainability? How do you demonstrate to the various audiences and constituencies that you are in fact concerned about this and that you are making progress in improving your property?

LEED Certification

Green Building Rating System



- Certified by the USGBC's LEED® Green Building Rating System™
- Recognized by the EPA's ENERGY STAR® program for energy performance

NOTE:

On a scale of 1-100, a score of **75** or more qualifies for a label

| | LEED for Existing Buildings (EB) POINTS | LEED for Commercial Interiors (CI) POINTS | LEED for New Construction (NC) POINTS |
|-----------|--|--|--|
| Platinum | 64-85 | 42-57 | 52-69 |
| Gold | 48-63 | 32-41 | 39-51 |
| Silver | 40-47 | 27-31 | 33-38 |
| Certified | 32-39 | 21-26 | 26-32 |

There are several widely-used standards for certain aspects of the discussion. The first is one developed and overseen by the United States Green Building Council. The USGBC is a nonprofit organization that has developed an independent green building rating system, fees for which support the institution. Through a comprehensive rating system that evaluates a building against a rigorous set of benchmarks and standards, the organization awards LEED (Leadership in Energy and Environmental Design) certifications. There are award levels ranking from certified to silver, gold and platinum based on how many LEED points are awarded in various sustainability categories such as Sustainable Sites, Energy and Atmosphere, Materials and Resources, Indoor Air Quality and Innovation. Points are awarded where and when a building achieves specified design or management protocols. The latest ratings systems for existing buildings give higher priority to energy conservation, with more points given for higher Energy Star ratings. Energy Star is a comparative percentile database rating system developed by the U.S. Environmental Agency (EPA) and the federal Department of Energy (DOE). There are separate rating protocols for various building types and for various phases of building life.



While the system continues to evolve, acceptance of the LEED standards is rapidly growing. A significant percentage of new commercial properties is being built to LEED standards. Many cities, counties and even states are beginning to legislate mandatory LEED compliance for new commercial construction. There are different categories of LEED, including New Construction, Core and Shell, Commercial Interiors (tenant improvements), and a relatively new Certification for existing buildings, operations and maintenance, LEED-EB: O&M. As of June 2008, there were only 85 LEED-EB certified projects compared to 1,090 for New Construction. However, there are now more than 1,000 buildings registered in the LEED-EB program and going through the certification process. There are certain prerequisites that must be met before a building can be certified and some of those may be either cost prohibitive, or in some cases, physically impossible to meet. LEED-EB is *not* for every building. In fact, one of the prerequisites is that the building must achieve a rating of 69 or better in the EPA Energy Star scoring, which means that for this item alone more than two-thirds of the existing buildings could not qualify for certification.

A second widely-used standard is the U.S. Environmental Protection Agency's [EPA] and U.S. Department of Energy's Energy Star® [DOE] program. Developed and managed through the EPA, this is a nationally administered benchmarking tool used to determine a building's relative energy usage against its peer set of buildings, after adjusting for consumption for particular uses, locations, occupancies and weather variations. A relative score of 1 to 100 is generated, and buildings in the top quartile scoring 75 or higher can apply for and receive an Energy Star plaque to demonstrate performance superior to at least 75% of similar buildings.



Another competing rating system is Green Globes managed through the Green Building Initiative. This is a program started in 1996 in Canada and widely used there. There is a certification process for both new and existing buildings. These rating systems evaluate properties on a 1000-point scale in such areas as waste, energy efficiency, hazardous substances, land use and design. The highest percentage of points is again awarded in the area of energy conservation, which accounts for 30% of the award. One to four Green Globes are awarded for various point scores. To a great degree the system is self administered online. To date there has been relatively limited acceptance of the system in the United States.



The Building Owners & Managers Association International (BOMA) is also working to develop a rating system entitled Accredited Building Program. The program would, among other areas of review and evaluate a number of a building's sustainability programs and practices. This program is in a beta test and may evolve differently through



that process, but currently there are areas of emphasis on energy, waste treatment, recycling, training and transportation. It is a requirement also that the building be registered and benchmarked through Energy Star.

Each standard has its weaknesses. LEED is complicated, expensive, takes months to earn and only represents a snapshot in time. There is no requirement to maintain any proper sustainability practices once the designation is earned, and in fact, buildings that achieve LEED-NC certification are not required then to mandate LEED certified interior improvements (LEED-CI) after the building opens. Due to the prerequisites, cost, time and management staff efforts to earn the certification, it will also likely be limited to only the highest performing buildings in a market, so most buildings will never be rated. Finally, if an owner does want to maintain the certification after four years, there is a new, similarly expensive and time consuming process for that.

Energy Star is only a measure of utility usage. While that is perhaps the single most visible metric of sustainability, and it can also be used to calculate a carbon footprint, it overlooks all other impacts buildings have, such as resource utilization and workplace environment. A high Energy Star score is important and probably indicates other good practices, but there is no way of telling.

Green Globes has not yet been able to gain any real traction in the U.S. While the process is much more user friendly, financially attractive and more achievable than LEED, this ease of entry and its' essentially self-administered program, although monitored at the end by an outside evaluator, is often seen as lacking the rigor and gravitas of the LEED process. It is essentially a qualitative analysis with limited quantitative outcomes.

Finally, the BOMA Accredited Building Program is a wide ranging review of a number of management programs and practices that award points in a number of areas in addition to sustainability. Some of these are far outside the sustainability area including the use of the BOMA lease form, use of the BOMA measurement system, as well as a review of financial practices and fire/life/safety. This is likely a good tool for judging the overall management practices of an office building and in time could become akin to the Good Housekeeping seal of approval for office buildings. However, for the singular purpose of evaluating the relative level of sustainability in a building, it is not the appropriate tool.

We currently have no real way of measuring the relative sustainability efforts of buildings.

What does this all mean? What it means is that we currently have no real way of measuring the relative sustainability efforts of buildings. And what that means is that those tenants, buyers, occupants, brokers, or anyone else who is trying to evaluate sustainability standards, in either an absolute or comparative way, have no really empirical way to do that. If sustainability is an important aspect of occupancy, and a tenant is working with a broker looking at multiple building choices, there is no definitive standard to measure one building against another: even if both buildings at sometime earned LEED certification; even if both buildings have Energy Star ratings and each earned a plaque. The broker can, and many are now beginning to, present a detailed RFP asking a series of questions related to sustainability practices and programs. But it will still be virtually impossible to accurately determine who is best.

Sustainability is also becoming important among the investment community. There is growing pressure at the SEC to require climate change risk disclosure for all public companies under regulation S-K. Many investment groups are already including an evaluation of sustainability matters in pre-investment due diligence, both as a hedge against future risks, and also as a potential re-positioning advantage where they think they can improve the status of the building and reap an additional financial gain by presenting a more sustainable building to the leasing public. The current sustainable status of a building, and the near-term potential for improvement, including associated costs, are becoming important acquisition considerations.

The resolution of relative sustainable practices is hard to determine. While there is a definite need to develop a widely accepted, comprehensive standard that covers all the issues, it is unlikely that this will occur soon. It seems that everyone has his own idea about what “sustainable” means and which aspects are most important. Is it only energy conservation and the resultant carbon footprint? Is it conservation of all resources? Or is it enlightened tenant or occupant behavior?

The complexities of wildly diverse data sets, and the many different applications and uses for the data, make the issue significantly more complex, as does the fact that buildings are not static commodities, but in fact are very fluid entities. A change in tenancy, operating hours, or the installation of a single piece of energy reducing technology can have a significant difference in the building’s sustainability profile. Conversely, a change in management or, most importantly, maintenance personnel, could have a major impact, positively or negatively. In other words, a building that can claim a high degree of sustainability today may not be as sustainable tomorrow depending upon changes in use, systems and management attention.

A final complication to the search for the Holy Grail of a universal standard is actually the recent surge in acceptance of the LEED standards themselves. The USGBC has effectively captured the high end of the market, and with so much attention being paid to that, including press, industry and regulatory awareness, there has been less momentum placed on developing another, perhaps competing, standard. Notwithstanding the previously delineated problematic issues inherent with LEED, no one is coming forward with something truly effective for the broader market.

The USGBC does suggest that the rating system is, in fact, for every building, even those that will not receive certification. However, the current usage is aimed nearly completely at those high performance properties that want, and can achieve, the certification. To some degree the value of the LEED program is the rigorous process and the reliance on the independent review that guarantees credibility. However, it is also true that the Energy Star system must be certified by licensed professional engineers and is based upon an extensive database of



equivalent buildings. Most buildings, either due to size, location, or ownership structure, will not pursue LEED in the near future.

Relative Versus Absolute

With this discussion as a backdrop, it is important to focus on the real core of the matter. Perhaps more important than a desire to discover where a building is in its relative market, is the need to improve each building's actual performance. It is a matter of relative versus absolute. The point of this is that what is most important in the ultimate scheme of things is not the certificate, but the outcome. It is not about the plaque, but more about the results. It is not about where you are, but what you will become.

Over the past several years many office buildings developed bad habits. It is really not anyone's fault. It had many causes but was primarily a product of market changes and the relative stability of energy pricing. Beginning in the early years of the decade, there were significant shifts occurring in commercial real estate. The capital markets were beginning to view real estate differently. Real estate was no longer being seen as a long-term, reasonably illiquid investment. Changes in the credit and capital markets were accelerating the resale period, making the market much more active and significantly reducing the traditional holding period of ownership. What at one time was a ten-year horizon now was shortened to as few as 12 to 15 months. And as credit costs continued to fall, capitalization rates did likewise, making real estate holdings more and more valuable without any change in the underlying financial status of the buildings. Buildings sometimes had three different owners in a 12 month period.

Net operating income (NOI), and especially operating expenses, were not as important in this new world. Buildings were bought to reposition and quickly resell into an ever improving market. Part of the reason for the rising market was also the dramatic influx of new capital from pension funds and private equity sources. More capital chased a fairly static pool of real estate assets. Real estate managers and their staffs were challenged to spend most of their time transitioning in new buildings and almost immediately preparing the property for resale. During 2006 at CB Richard Ellis, nearly 60% of a 650-million square-foot managed portfolio was in some state of transition. Sustainability was not high on the list of activities.

During this time of rapid market activity there was also a period of relatively flat energy costs. The first half of this decade saw virtually static utility costs. There was limited price pressure on this operating expense item, which again reduced visibility or concerns about sustainability that might have been influenced by costs.

Then everything changed. The capital markets significantly slowed with the ongoing collapse in the credit market. Ownership periods have lengthened and operational issues have become much more important. Energy prices have spiked and there appears to be no end in sight for the increases. And, finally, sustainability now matters.

The convergence of these issues has resulted in a significantly increased focus on operating issues. Many buildings had developed bad habits. Many buildings are run to either satisfy the loudest, most demanding tenant, or to the capabilities of the least skilled and experienced chief engineer. Either option means trouble. In almost every case buildings are not running to their design capabilities due to changes made after commissioning.

The most significant improvements can be made in the buildings that are currently the worst performers.





With the renewed focus on operations however, each building has the opportunity to improve performance. Almost any building can improve and formulate a plan and program to make that happen. The most significant improvements, including those related to sustainability, can be made in the buildings that are currently the worst performers. It is all a matter of incremental improvement over time.

As a first step, every office building should register with the EPA Energy Star program and develop a starting benchmark. One cannot improve what one does not measure. This benchmark also allows a building's owners to understand what level of work can or should be done. An owner of a building that is already at or near the top of this rating scale should not expect that it can make many improvements in energy costs. A building with a relatively poor number however, likely has many areas for improvement. Many of the first steps that can be taken are often times achievable with low, or no, costs and can produce a rapid payback.

Once a building has received its initial benchmark there can be a tendency to either coast on high results or become depressed and throw in the towel for an especially poor result. It seems that the most focus goes to buildings that are near the 75th-percentile level and people strive to make appropriate changes to earn the star. Every building can be improved and the opportunity for the greatest improvement lies in those buildings with the worst initial scores.

At the outset, a building can undergo a retro-commissioning where the building systems and practices are evaluated against the original design criteria. Most buildings tend to be managed according to either tenant demands or staff capabilities. These will be discovered during the retro-commissioning process and can be repaired or changed. A typical retro-commissioning will achieve a 5-15% improvement in energy usage and have a payback of less than one year.

Cost Reductions

| ENERGY | CARBON | WATER | WASTE |
|---|---|---|---|
|  |  |  |  |
| 30% | 35% | 30-50% | 50-90% |
| Greater efficiency & immediate cost savings | Lower CO ₂ with long-term environmental benefits | Cost savings & conservation of resources | Lower disposal costs and reduced environmental impact |

One should also examine hours of operation. Sometimes automatic clocks have been set once to accommodate a tenant's special needs and then had not been reset, so the building continued to operate at non-required hours. A more frequently found issue is Saturday hours. All office buildings establish normal operating hours and specify these in their lease terms. Over the past several years it has become the norm for most buildings to include some portion of Saturday in these hours. That may no longer be necessary or may be altered. Since this is a matter of current lease standards, a change of this nature will require approval from the

building tenants. When this is proposed as part of a larger, comprehensive sustainability program and the cost and environmental benefits are enumerated, almost universal acceptance can result. Buildings can be run “on demand” instead of “just in case” and can meet little resistance. The normal six hours of Saturday operation represent approximately 10% of the hours a building is run. If the HVAC system utilizes 50% of the energy used, this small change can reduce usage by 5%, and with no capital costs or physical changes to the building.

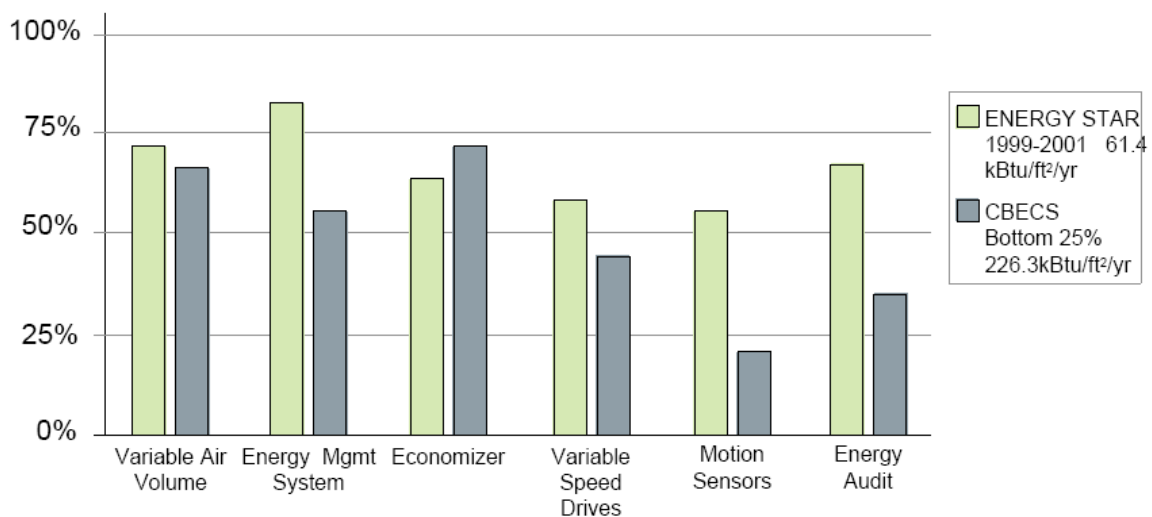
Another area under consideration is a change to daytime janitorial services. Nighttime janitorial service is the expected norm, but with new quiet vacuums and an increased desire for sustainability, that may change. In pilot programs all over the country there is a rising acceptance of altering the time of cleaning to daylight hours. This also improves working conditions for the cleaning staff and, further, has even reduced janitorial complaints as the staff is visible and special requests can be handled immediately. Reducing nighttime lighting can reduce energy costs by as much as 5%, again without any capital expense.

Other low cost and no cost approaches include installation of motion sensors in every infrequently occupied space or room, the replacement of all incandescent lights with compact fluorescent lights (CFLs) and the setback of temperatures for all boilers and water heaters. Some owners are also beginning to experiment with slightly higher or lower temperature settings for the heating and air conditioning systems and may change these standards in lease forms as well.

After all low and no cost changes have been made, there may be an interest in considering the evaluation and introduction of more capital intensive efforts to further save energy. These may include lighting retrofits, economizers, which are mechanical devices intended to reduce energy consumption, and variable speed drives. All have their place in an energy-efficient building. However, before making any of these significant capital investments, we are very careful to have made certain that all maintenance and management concerns have been addressed first.

Energy Performance vs. Technology

Technology doesn't always equal performance...



Note: “CBECS” is the Energy Information Administration's Commercial Building Energy Consumption Survey

A few years ago, the EPA wanted to understand the role that technology and hardware played in reducing usage so they conducted a study comparing the top quartile buildings, those that had earned the Energy Star plaque, against the bottom quartile. Essentially EPA compared the best against the worst. What it was testing for was to ascertain the level of several energy management programs and technology in each class of buildings. What it found surprised them. In nearly every category the buildings were similar. There was very little difference between top and bottom in the percentage of buildings that had variable air volume (VAV) systems, variable speed drives and energy management systems. In fact, more of the lower performing buildings had economizers installed than the higher set. The areas that had the largest differences between the two were in energy audits and motion sensors — the two cheapest programs. The primary conclusion from the survey was that management practices trump technology alone. Management plus technology is the best winning combination.

In addition to energy, a broad-scale sustainability program should also consist of a number of other areas: a measurable recycling program; a comprehensive plan for green cleaning including both products and processes; a plan for water conservation and air quality considerations including use of low volatile organic compound (VOC) products. Perhaps most importantly, one should include a program of interactive communication with the tenant base. Many aspects of sustainability require active cooperation and endorsement of the tenant population to gain full impact.

So where does this all lead us? On the one hand there is no question that sustainability is becoming mainstream and there is a growing level of sophistication about the language and general expectations. On the other hand, there is no consistency of outcomes and with no current, consistent way of relating one building to another, there are opportunities for hype and hyperbole to trump reality. There also is a tendency to focus attention on the star properties or the new, shiny LEED-certified structures. The day-to-day battles and biggest victories over time will actually be won on the average buildings. These are the buildings that have the most potential for improvement, and this existing building pool actually represents the largest portion of the market and demands our attention.

Impact of Commercial Buildings

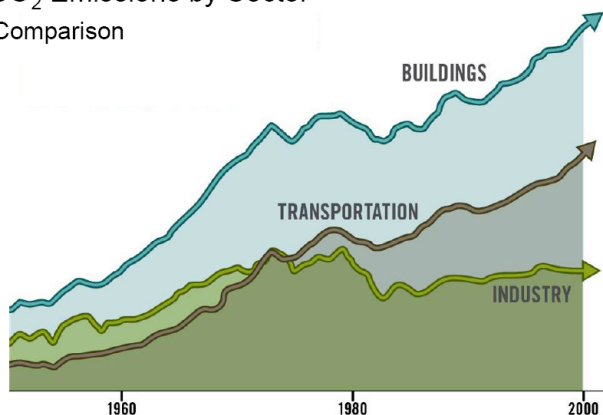
Buildings consume:

- 40% of total energy
- 65% of total electricity
- 30% of raw materials
- 12% of potable water

Cleaning buildings require:

- 5 billion pounds of chemicals
- 4.5 billion pounds of paper
- 36 billion plastic trash liners
- 20 million vacuum cleaners

CO₂ Emissions by Sector
Comparison



The office building industry plays a key role in the climate change debate. The scale of the energy use, the amount of total emissions, and the role office occupancy plays for a company in its sustainability efforts all make the office building a critical element in the sustainability dialogue. And all of this needs to be done in a cost-effective way.

Sustainability in office buildings sits at the nexus of capitalism and altruism. The challenge for the industry now is to find the balance between the two and to do so in a transparent way that will allow the buying public to know what it is buying in fact.

Developing the Nines Hotel: Challenges & Solutions

Donald Eggleston, President, SERA Architects

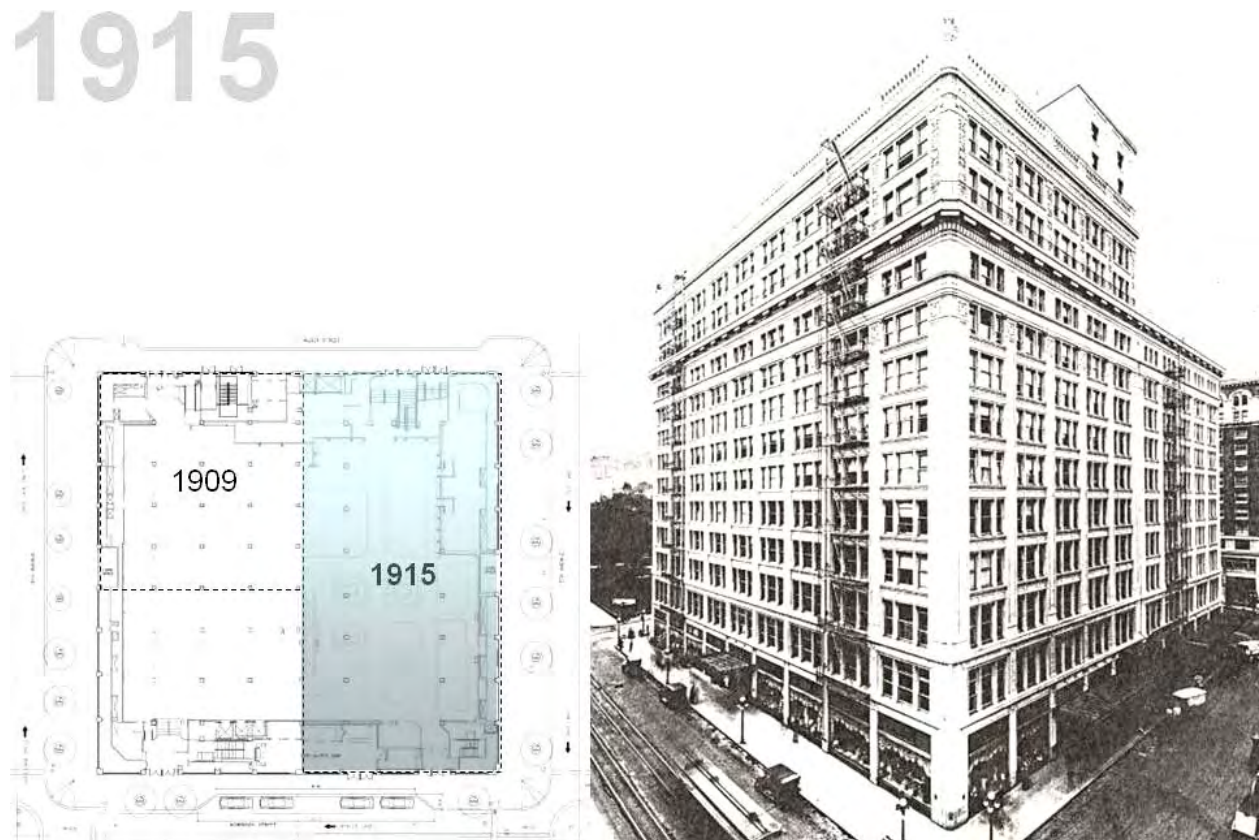


In October 2008, Sage Hospitality opened the doors of its new downtown Portland hotel, the Nines, operated by Starwood. The story behind the hotel illustrates the opportunities, challenges, and complications of renovating a downtown Portland landmark. Designed to reflect the elegance of the historic Meier & Frank building, the new Nines Hotel culminates years of work to partner public and private sector resources to rehabilitate a downtown landmark.

Since 1908, the Meier & Frank building has been an anchor for downtown retail activity. While most people think of the building as a single structure occupying an entire block in the central city, few realize that the Meier & Frank building is actually an aggregate of three different buildings, each one built in a different decade. In keeping with the building's genesis, the current \$160-million rehabilitation aggregated many disparate needs of public and private stakeholders. This article describes multiple historic, economic, public/private, design, and management challenges requiring innovative solutions to achieve historic rehabilitation, adaptive reuse and sustainable design on this scale.

Portland's Retail Heart

The Meier & Frank Building site was first developed in 1898 as a 5-story structure known as the Whidden & Lewis building. A 10-story annex, the Doyle & Patterson building, was built in 1909 and connected to the main department store. In 1915, the original 1898 department store was demolished and a new 15-story structure was built on the same footprint, followed by another 15-story addition built in 1932.



The three structures comprising the Meier & Frank Building totaled 650,000 square feet, making it the largest commercial facility in the State of Oregon until the 1983 construction of

Portland's U.S. National Bank Tower. It was the first department store in Portland to be clad in white-glazed terra cotta and was the location of the first escalators installed on the west coast.¹

The building was listed on the National Register of Historic Places on July 8, 1982. As detailed in the National Register nomination, "The Meier & Frank Building achieves significance as Oregon's earliest example of the white terra cotta commercial style department store, and as the first major commission for A.E. Doyle" who was a leader of the Portland architectural community during the years 1907-1928.

Meier & Frank was acquired by the St. Louis-based May Company in 1966, though May kept a regional office in the downtown Portland flagship store. Given its location adjacent to Pioneer Courthouse Square, East/West MAX light rail lines, and the downtown Pioneer Place, the Meier & Frank Building has long held its logistical and historical position at the retail heart of downtown Portland. However, the once-thriving store increasingly suffered from a lack of reinvestment as retail trends lured shoppers away from downtown department stores, resulting in declining revenues for the longstanding business.

Increasing space became available in the building as the store's merchandise lines continued to shrink and, by the 1990s, sales per square foot had begun to slip. In 2002, the May Company moved 600 jobs from Portland to its headquarters in Ohio, leaving the downtown Portland building with 200,000 empty square feet.

A Downtown "White Elephant"

At 650,000 square feet and rising 15 stories, the Meier & Frank building's struggle for success adversely impacted Portland's downtown. The design process of the rehabilitation effort began in 2001, when the Portland Development Commission (PDC) formulated the goal to keep the department store downtown and to retain the vitality of the landmark location. The long-standing question for owner, May Company, was how to rationalize the investment of millions of dollars for a location that many saw as a liability. Compounding the project's challenges, any renovation of this historic building would require approval not only from the City of Portland's Landmark Commission, but also from the National Parks Service, due to its listing on the National Register of Historic Places.

The architect, SERA Architects, and structural engineer, KPFF Consulting Engineers, were retained to study the structure. The team prepared a feasibility study outlining the seismic upgrade opportunities, costs and benefits of upgrading the historic building. This study outlined development options for the building including consolidating the department store on the lower floors and renovating the upper floors for condominiums, apartments, office or hotel. The study also provided PDC with the materials to illustrate the property's potential for adaptive reuse.

¹ Source: *Saving One of America's Great Stores: The Renovation of the Meier & Frank Building*, Heritage Consulting Group, 2008

Designed from the Outside

The team's study concluded that the Meier & Frank building had suffered from a lack of investment over the years, requiring fire, life safety as well as mechanical, electrical and plumbing system upgrades, and a full seismic upgrade to accommodate new uses. The seismic issues posed big challenges for the project's design, as well as its budget. To make the rehabilitation pencil out for the May Company, the design and construction team was asked to bring the entire building up to current code requirements for seismic performance, while at the same time maintaining the occupied retail space as fully operational. This challenge was compounded because the team was rehabilitating not just one building, but three separate buildings on the same block at the same time.

Early in the project, the team determined that the most common solution, concrete shearwalls for seismic reinforcement, would not be feasible as the concrete's mass would subtract valuable square footage from the ground floor retail use. A relatively new technology, viscous dampers incorporated into the existing steel frames, was chosen for flexibility and proven performance in a seismic event. While the approximately \$8 million cost of the viscous dampers might be considered expensive, the dampers made the renovation possible because the technology is less disruptive to the existing building structure and accommodated the restoration efforts to preserve integrity of its historic architectural fabric.



Development Opportunities

A key part of the PDC's study was to outline potential development options for the building, including consolidating the department store on the lower floors and renovating the upper floors to condominiums, apartments, office or hotel. The opportunities for adaptive reuse were constrained by the building's 40,000 square-foot floor plates, limited parking options and deep cavernous floor plans that would never be considered Class A office space. According to John Echlin, Design Principal at SERA Architects, this was no easy task. "It took creative thinking to renovate the building from a seismic perspective, maintain the building's historic qualities, and at the same time find a new use for the building's upper floors," said Echlin.

Given Portland's projected growth in population, residential development was considered as a potential opportunity. Affordable apartments were initially considered, but taken off the table as the project would not have generated sufficient return on investment. Not only did the building's layout make conversion to high-end condominiums uneconomical, it was also determined that federal Historic Tax Credits would not apply to condominiums in the building. Condominium development was further complicated by limited potential for location and ownership of parking spaces.

Parking emerged as a significant issue from both bottom line and design perspectives. The team initially explored turning the basement levels of the building into parking space. However, with the highest-value square footage embodied in the ground floor retail space, the May Company was not interested in losing ground floor space to parking ramps. Once it was determined that parking would not work in the building, residential uses such as condominiums were no longer feasible options.

Expanded retail use was briefly considered, but discarded as a viable option, as it is extremely difficult to successfully operate retail on upper floors. The team explored office and hotel uses as they can be made to work with offsite and valet parking. Converting the historic building to office use would have resulted in Class B space. At the time, Portland's office market would not support 300,000 square feet of new Class B office space. In addition, office use was not a publicly accessible active use and potential rents did not appear able to support renovation costs. The hotel option emerged as the most promising alternative due to Portland's improving occupancy rate and rising room rates, apparently viable economic returns, and ability to use existing parking garages with valet service.

While the team worked towards the best model for the building's adaptive reuse, PDC was concurrently engaged with Portland's downtown retail association, the Association for Portland Progress (now the Portland Business Alliance), to study the entire downtown Portland retail core. The broader study was focused on creating strategies for downtown retail revitalization, job-creation, improved tax-base, and other shared economic benefits. Redevelopment of the Meier & Frank building was frequently discussed as PDC and the downtown retail association wrestled with what to do with what was considered as an underperforming white elephant.

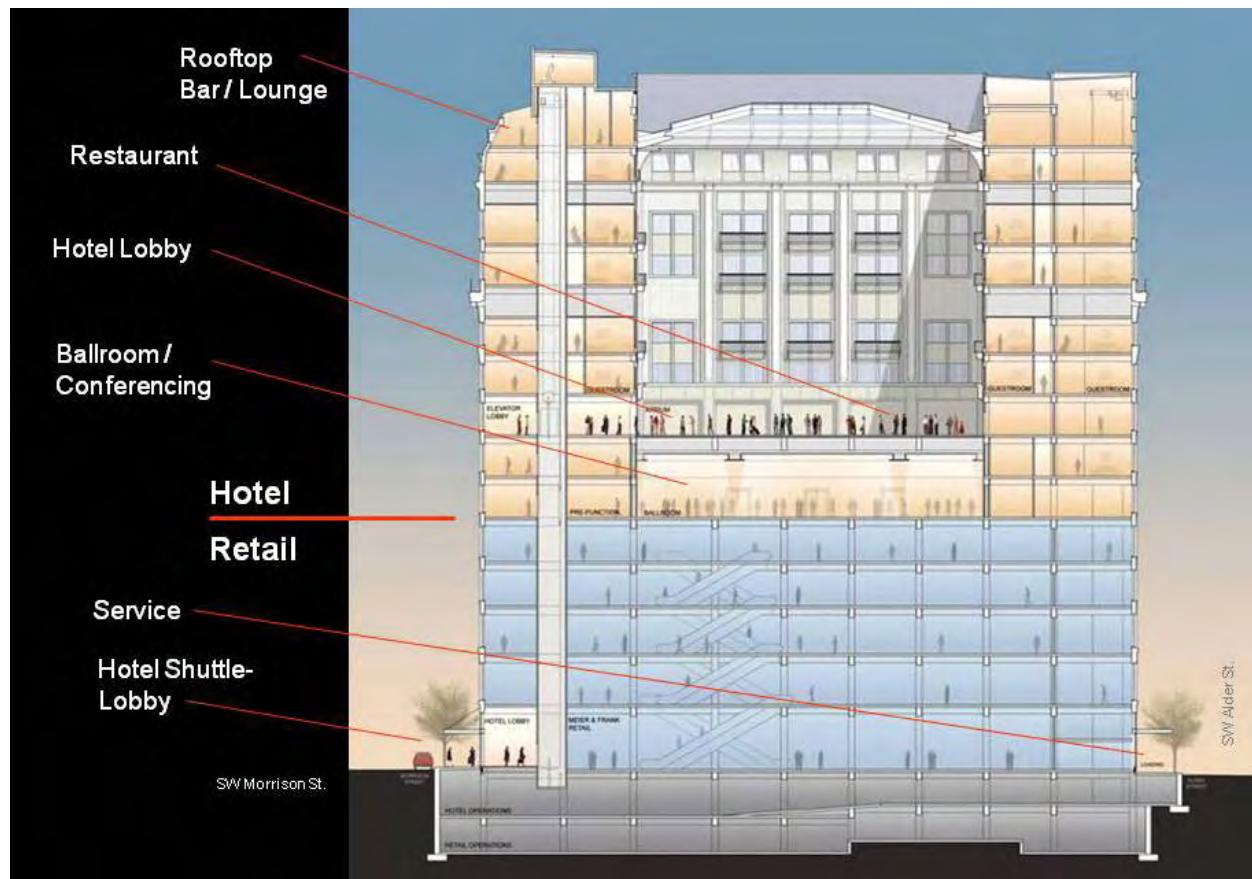
"We formed a citizen's advisory committee, a technical advisory committee, and worked with retail consultants to look at downtown strategies. Everyone concluded that we needed to keep

the Meier & Frank department store downtown because it was still a draw for people and the company did a huge amount of advertising from which the rest of downtown benefited. Making sure we kept the historic building anchored with a department store and finding better uses for the upper floors became our number one priority,” said Ross Plambeck, Project Manager for the Portland Development Commission.

A Plan Emerges

In 2002, the Denver, CO-based hotel developer, Sage Hospitality Resources (Sage), visited Portland looking for potential sites on which to develop a large luxury hotel. Sage had been surveying Portland’s emerging, vibrant downtown culture and had determined it to be a good match with their track record for converting high-quality historic buildings into hotels. The Meier & Frank building immediately attracted Sage’s attention. SERA Architects embarked on a study for Sage and PDC to determine how many hotel rooms could potentially be developed and what it would take to renovate the historic structure.

With guidance and aid through the Portland Development Commission, Sage and the May Company structured a complicated renovation project. Sage’s proposal included purchasing the top nine floors of the building in which to construct a 331-room luxury hotel. Hotel amenities would include a 7,000-square foot skylit atrium, 14,000 square feet of ballroom and meeting facilities, lobby, restaurant and roof-top lounge.



The May Company would completely rehabilitate the interior five lower floors of retail space, while remaining in continuous operation. New lighter and brighter storefronts and awnings would generate mid-block retail activity opening to sidewalks on 5th and 6th Avenues while reinforcing retail energy north on the downtown Transit Mall.

The project would include complete interior and exterior rehabilitation, as well as seismic upgrades utilizing viscous dampers throughout all three existing structures. After working with PDC to set the stage for the project, SERA Architects would be retained as the shell architect and architect of record for the project, responsible for integrating the seismic technology into the building, designing the architectural changes to the existing structure and coordinating with sub-consultants and three interior design firms. SERA would provide the design, process it through governmental agencies, prepare and coordinate construction documents with the various disciplines (including structural, civil, mechanical and electrical engineers, audio-visual specialists and graphic artists) and coordinate with the hotel interior designer, hotel restaurant designer and rooftop lounge interior designer.

The combination of the new hotel and rehabilitated, rebranded department store was projected to create and retain a significant number of jobs, adding to downtown Portland's redevelopment energy. Based on information provided by PDC, the Meier & Frank renovation project would generate over 800 construction jobs, as well as 370 permanent operations jobs. In addition, the revamped facility would contribute over \$70 million in federal tax revenue as well as \$45.4 million in state and local tax revenue over a 10 year period.

Putting the Deal Together

The \$160-million renovation of the historic Meier & Frank building was made possible by a complicated financing package that effectively leveraged urban renewal funding. Dividing the building into commercial condominiums was the crucial first step in making the deal work for all parties involved. The May Company, which was sold to Federated, which rebranded the store as a Macy's, sold floors six through 16 and the exterior shell to Urban Heritage Portland Hotel LLC, a limited liability company created by Sage Hospitality Resources as the ownership entity. The proceeds from this sale, \$20 million, was combined with \$10 million in cash from Macy's corporate headquarters to consolidate and modernize retail operations on floors one through five plus the basement. The upper floor buyer then undertook a \$133-million project to seismically upgrade the building, rehabilitate the exterior and adapt the upper floors for hotel use, including a 12,000 square foot rooftop restaurant and lounge, and a central ten-floor atrium.

Four loans from the Portland Development Commission totaling \$17 million enabled the project to move forward. According to PDC documents:

1. The first loan aided in funding the seismic retrofit. It was \$8.625 million over 25 years with a 3% interest-only payments during the first three years, followed by 3% principal and interest payments based on a 32-year amortization schedule. At the end of the 25th year, the owner would make a final balloon payment.
2. The second loan was a bridge loan of \$2 million over an eight year period at 3% with interest-only payments for the first three years followed by interest plus \$100,000

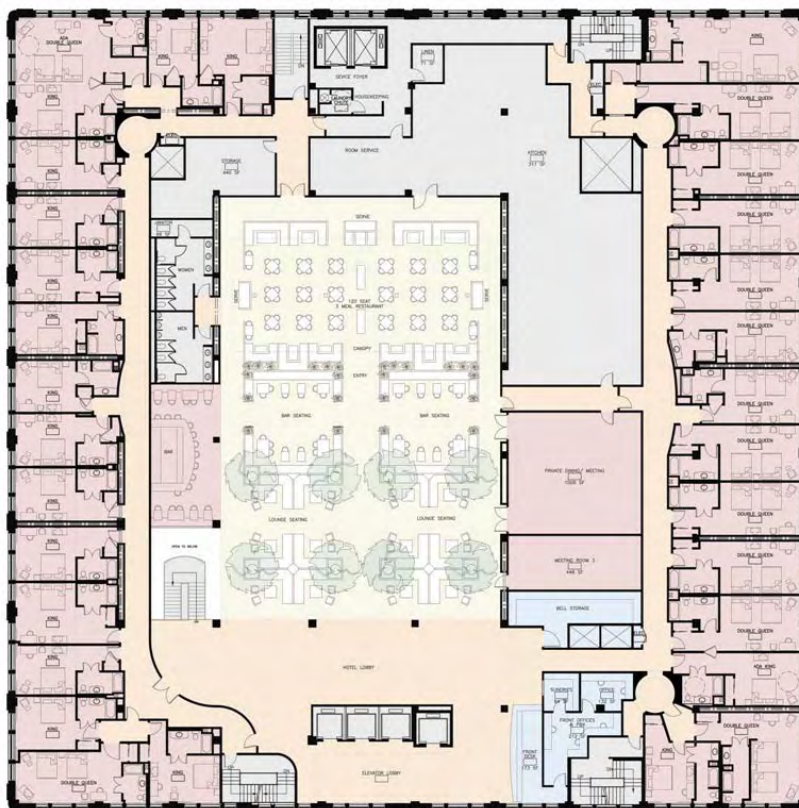
annual principal payments in years four through eight, with the balance due after the eighth year.

3. The third loan helped fund the project. It was a \$3.3 million loan for 15 years with a sliding interest rate that ends with a balloon payment.
4. The fourth loan of \$3 million is a seven-year term loan at 5% interest.

In addition to these loans, Sage was responsible for \$36 million in developer equity funds. This included the 20% federal investment historic tax credit, New Market Tax Credits (NMTC), and energy tax credits. Sage also secured a \$46 million mortgage and an \$11-million mezzanine loan. PDC assisted Sage in preparing the NMTC application with Sage being awarded \$72.5 million in tax credits, the largest single allocation to a single project in the country.

The federal investment tax credits for historic preservation, estimated at \$21 million, required that the building be rehabilitated according to the U.S. Secretary of the Interior's Standards for Historic Rehabilitation. Coupled with the \$72.5 million New Market Tax Credits, this equated to approximately \$28.2 million of equity for the project. Sage's financial package was completed with a first mortgage of \$46.7 million plus a mezzanine loan of \$10.7 million.

Because the Portland Development Commission requires a LEED Silver Certified level of sustainable design and environmental efficiency for projects it helps finance, the project has been submitted for LEED Certification by the U.S. Green Building Council.



Hotel Design Challenges

When studying whether an existing building is a good candidate to be rehabilitated into a hotel, it is common to begin by working out the typical guestroom floor first to see how well it accepts the module of a standard hotel room. If the existing window spacing, column bay spacing and building depth work out well, there is a good chance of creating an efficient floor plate that will maximize the number of guestrooms and contribute to a workable pro-forma. In the Meier & Frank Building, the window spacing is generally 14 feet for two windows, which worked out reasonably well.

One of the project's biggest design challenges was the unique grid structure of three different buildings. The column spacing was somewhat odd, exacerbated by the fact that the grid differed in each of the three phases of the original construction. The team customized the design to fit existing conditions while at the same time meeting the Starwood brand's national standards for luxury hotel rooms.

While appropriate for retail, the 200-foot by 200-foot floorplate — nearly an acre of space on each floor — presents an inherent challenge for a hotel, since hotel rooms are relatively small and need both light and air which large floorplates preclude. The solution in this case was to cut an atrium space into the building, bringing in light and creating an efficient double-loaded corridor layout for the guestroom floors. Fresh air would be ducted into the atrium, as well as to all rooms. This approach would require the removal of nearly 70,000 square feet of total floor area. In addition, cutting out the atrium reduced the mass on the upper floors of the building, reducing potential seismic stresses.

The atrium approach also allowed resolution of a second major challenge in converting an existing building into a full service hotel, that of finding sufficient clear span space for a large ballroom. By cutting the atrium down to the 6th level of the building and adding back an infill floor at 8th level, a new double height clear-span 7,200-square-foot grand ballroom space was created as a key hotel amenity.



Having worked out the design approach for the upper floors, the team still needed to address how the hotel would function sitting on top of five floors of retail space and how best to manage the vertical separation the mixed-use occupancy would create. The main issues to resolve were the guest arrival sequence, back-of-house functions, and vertical connections through the retail space.



The ground level sales floor is the most valuable square footage for the department store, so it was critical that the hotel functions minimize their size on that level. To solve this issue, the hotel would occupy a 900-square-foot “Welcome Lobby” on the ground floor located along SW Morrison Street, which is the vehicular drop-off point for hotel guests. That lobby would contain some valet and bell functions, a small seating area and access to the hotel guest elevators. The guest elevators connect to the main lobby on level eight, the guestroom floors, and to the feature top floor lounge of the building.

The back-of-house elements including employee facilities, housekeeping, maintenance, and mechanical equipment, were located on the first basement level (the building has four levels of basement) taking up about half of the floor’s square footage. Connection to the hotel above and to the street for loading was achieved via the addition of two service elevators that connect

from basement to the top floor with access to the Alder Street loading area that both the hotel and department store share on the ground level. An employee entrance and stair to access the back-of-house functions on the lower level was also added.

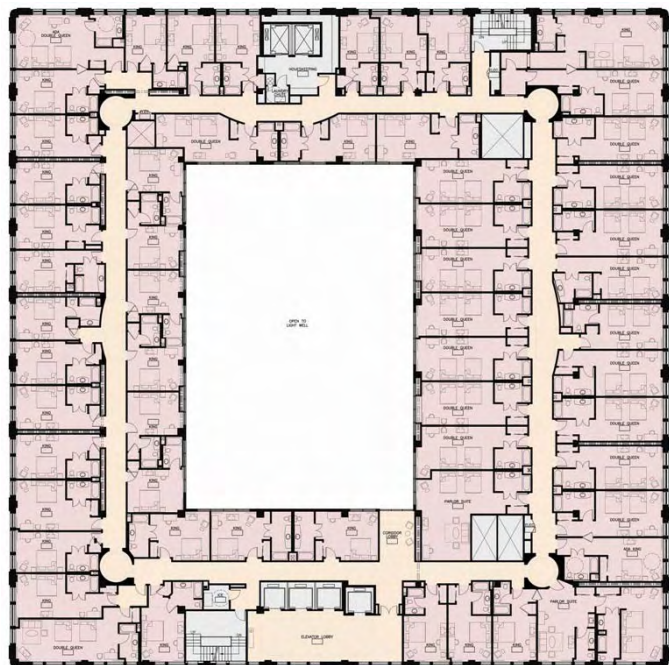
These approaches to the guest arrival sequence and location of back-of-house functions allowed the hotel to occupy only approximately 2,000 of the 40,000 square feet of area on the ground floor. Minimizing this area and creating an integrated vertical connection of both guest and service traffic was a major design contribution to the deal's success.

Greened to the Nines

While the PDC's participation mandated a concerted effort at green building, Sage had no prior practical experience of sustainable practices or with LEED projects but did resolve to create its first LEED-rated hotel. Although SERA's team had previously designed numerous LEED-rated projects, setting out to design a LEED-rated hotel in 2004 was fairly uncharted territory. At the time, only one hospitality property in the U.S. had received basic LEED Certification (the current number is still below ten). The major brands did not yet recognize the demand for green hotels and they had no green operations or development policies in place. There were no data on construction cost impacts for LEED specific to the hospitality industry. Also, there was a perception that greening a property meant reducing the quality of the guest experience in terms of finishes, lighting, and shower quality.

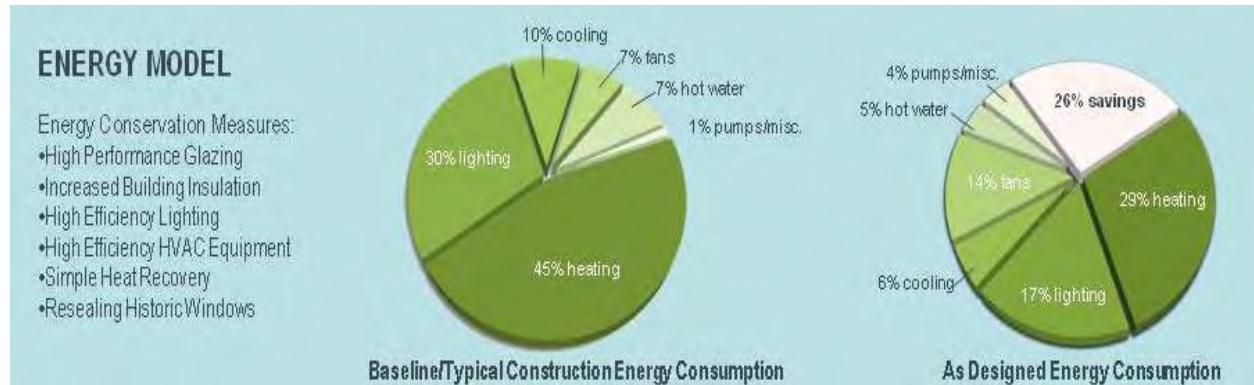
The challenge was presented to the team to deliver a luxury-level LEED Silver hotel with minimum impacts on the construction budget and no negative impacts to the guest experience. The design approach focused on four elements; energy efficiency, water efficiency, indoor environmental quality, and maximization of available incentives.

The approach to energy efficiency incorporated "state-of-the-shelf" technologies using the best of available products with which the contractor and building trades were already familiar. This included high-performance glazing in the new infill elements, resealing the existing historic windows, increased insulation in the additions to the building, high efficiency lighting utilizing both compact fluorescent lighting [CFLs] and light emitting diodes [LEDs], high efficiency mechanical systems, and heat recovery. The HVAC system consists of central high-efficiency condensing boilers, fired by natural gas, for heating and a water-cooled chiller and cooling tower. Each individual room is equipped with a fan-coil heat-exchanger unit with heated water and chilled water coils to control temperature and humidity. The exhaust air from the guest rooms is collected for heat recovery to preheat outside air for guest room ventilation, which is delivered



through the fan coil units. This combination of elements resulted in a 26% reduction in energy consumption.

These measures cost \$291,750 more than what would have been spent typically, but would pay back over \$100,000 per year in energy savings. The efficiencies would also help to qualify the project for over \$317,000 from the State of Oregon Business Energy Tax Credits (BETCs) and the Energy Trust of Oregon grants. The scale of incentives available to the project and the potential for operational savings made achieving energy efficiency an obvious and rewarding goal for the project.



The effort to reduce water consumption brought up a significant challenge for all hospitality projects, the potential clash between guest comfort and green initiatives embodied in the showerhead. Quality of the shower experience is one of the elements on which guests focus and can be a source of constant guest complaints if a property has low water pressure. Though options for showerheads that operated below the industry standard 2.5 gallons per minute were investigated, it was decided it was best to use standard showerheads and look for efficiencies in other places. The final strategy used water-managed, back-of-house fixtures, as well as water-saving measures in the guest rooms, such as aerators on the sinks and dual-flush toilets. This resulted in a 28% efficiency savings in water consumption over the baseline. One of the biggest benefits was receiving a reduction in City system development charges based on the reduced water and sewage use. This amounted to a \$280,963 savings to the project, while only costing an additional \$32,300 for the fixtures to achieve the efficiency.

The third element was to focus on improving indoor environmental air quality. Though these measures would not pay back like those for the energy and water initiatives, they would contribute to a recognizably improved experience for guests and employees. Measures here included low volatile organic compound [VOC] -emitting paints, adhesives, sealants, and carpet systems throughout the hotel.

The result of these strategies has been delivery of a LEED Silver targeted design with a premium of only 1.2% of construction costs (*see sidebar on the next page*). After incentives are factored in, this premium is reduced to just 0.2% with the utility savings covering the remaining premium in a period of 18 months. The utility cost savings will continue to payback over time, resulting in nearly one million dollars in operational cost savings over ten years. With an annual operating expense savings of \$100,000 from an incremental investment of

\$730,000 the return on cost is 13.7%. This does not include the additional cash incentives for water and energy efficiency of \$579,000 in the first year.

| COSTS | | |
|-------------------------------------|----------------------------|-------------------|
| Soft Cost Premium | | -\$210,260 |
| Hard Costs | | |
| Sustainable Sites | -\$59,660 | |
| Water Efficiency | -\$32,300 | |
| Energy & Atmosphere | -\$291,750 | |
| Materials & Resources | -\$100,000 | |
| Indoor Enviromental Quality | -\$32,000 | |
| Innovation & Design | -\$4,000 | |
| Hard Cost Premium | | -\$519,710 |
| Soft & Hard Cost Premium | | -\$729,970 |
| | 1.2% of construction costs | |

| INCENTIVES | | |
|-------------------------------------|----------------------------|-------------------|
| Energy Trust Incentives | \$101,104 | |
| BETC Tax Credit (pass thru value) | \$216,104 | |
| Reduced City Development Charges | \$280,963 | |
| Total Incentives | | \$598,171 |
| Cost Premium Less Incentives | | -\$131,799 |
| | 0.2% of construction costs | |

| PAYBACKS | | |
|---------------------------------|--|------------------|
| Straight Pay Back Period | | 18 Months |
| 10 Year ROI | | \$992,880 |
| Return On Investment | | 37.10% |

While it took more than a decade to complete, the complicated and challenging project used a wide variety of historic, design, construction, economic and management tools and techniques to save a Portland landmark.



Downtown Condominiums Revisited

Greg LeBlanc, MBA, RMLS Fellow, & Certificate of Real Estate Development Student



Condominium development in Portland has gathered significant attention over the past year. In little more than a decade, Portland has seen an older industrial district turned into what we now know as “The Pearl”, a district filled with trendy restaurants and nightclubs, along with luxury rentals and condominiums. In recent years the rate of condominium development in Portland expanded beyond the Pearl to the west side of downtown and the South Waterfront. Since 2006, there have been nearly 3,000 condominium units added to these three areas in Portland.¹

Last year I prepared an article analyzing the downtown Portland condominium market, which appeared in the [3rd Quarter edition of the 2007 Quarterly](#). At the time two notable projects, Opus Development’s **Ladd Tower** [220 units] and Robert Ball’s The **Wyatt** [245 units] had switched from condominiums to luxury rentals in anticipation of decreased demand and trouble with the mortgage market. Since that time, four other condominium projects (Williams & Dame’s **2121 Belmont** [109 units], Gerding-Edlen and Williams & Dame’s the **3720** (now the **Ardea**) [323 units], Gerding-Edlen’s **Cyan** [354 units] and one of the three **Harrison Towers** [188 units] being re-developed by Williams & Dame and Bean Investment Real Estate) have converted to luxury rentals. These six conversions represent a purging of 1,439 units from the condominium market.

Based on analysis of the most recent condominium sales figures, Portland has a significant build up of inventory, including over 800 units from new buildings constructed within the last two years. Coupled with the current difficulties within the real estate market, the average time

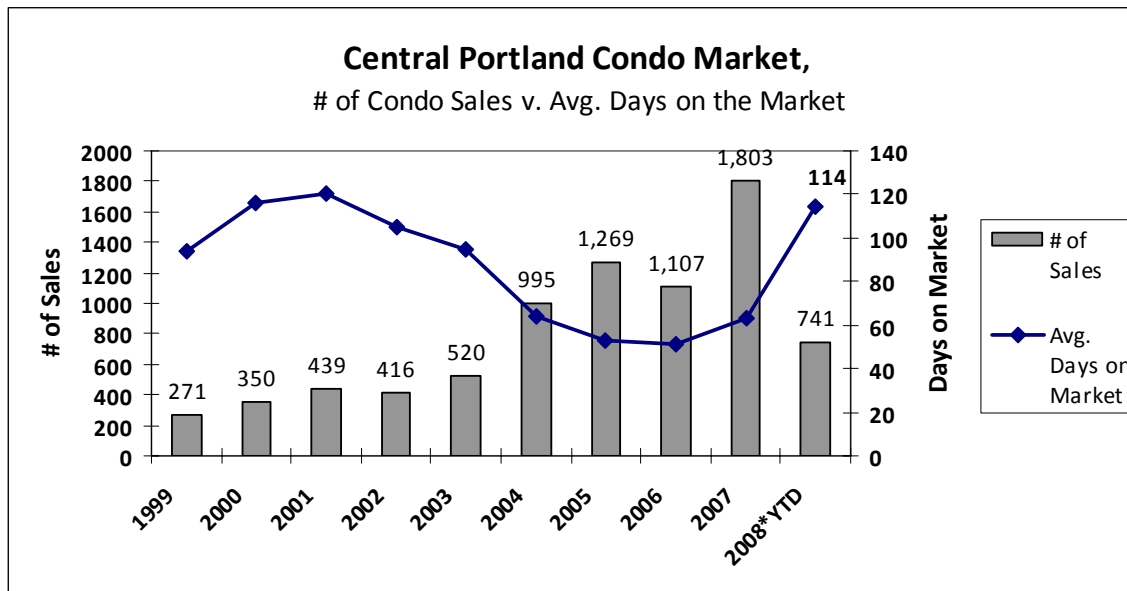
¹ Source: Jacob Becker, Realty Trust City

to sell a condominium this year in central Portland has increased dramatically over 2007. While this is consistent with the detached residential housing market, condominium sales are now taking an average of 114 days to sell. In comparison, houses on the west side of Portland are averaging only 67 marketing days.

Conclusions from the 2007 condominium article opined that (1) the number of condominium sales was declining; (2) median sales prices were leveling; and (3) condominium sales over one million dollars were down for 2007. The 2007 article utilized sales figures from the MetroScan database for 2004 through July 2007. An updated analysis of condominium sales recently completed using both MetroScan and RMLS² figures show that conclusions reached in 2007 did not hold true based on stronger than expected condominium sales in the later half of the year.

In fact, 2007 turned in the most sales for a single year over the past decade with over 1,800 condominium sales. A strong component of these sales, however, was contract sales. In these sales buyers provide an earnest money deposit, usually before construction completion, to claim a specific unit at an agreed price. Once the building receives final occupancy approval the purchaser can close the sale.

Based on historic high level of sales it may appear that the troubles in the condominium market are not as dire as originally projected. However, one has to keep in perspective the number of units added to market. Since late 2006, 17 high-rise condominium buildings with over 2,800 units have been added to the market. In 2007 alone there were 1,473 condominium units delivered. These figures do not even consider the numerous condominium conversions that also occurred over this time period.



*YTD refers to sales through September, 2008.

The question then becomes how many sales in 2007 were for units purchased from new construction and how many were for resale units? Analysis shows that 864³ of the 1,803 sales

² Sales information extracted for all properties classified as condominiums by the county assessor. Sales were tracked through the following zip codes that essentially marked the borders for each neighborhood: 97210 (NW Portland), 97209 (Pearl), 97201, 97204, 97205 (Downtown), and 97239 (So. Waterfront and Johns Landing).

³ Source: MetroScan

in 2007 came from new buildings delivered to the market in 2006 and 2007. (See table below.) This equates to only 58 percent of the 1,473 new construction units completed in 2007, which means 2008 started with an overhang of 619 condominiums not yet sold, on top of the 617 units scheduled to come on-line this year.

| 2007 NEW Construction Condo Sales | |
|--|------------|
| | # of Sales |
| So. Waterfront | 240 |
| NW Portland | 87 |
| The Pearl | 326 |
| Downtown | 211 |
| Total | 864 |

Additionally, it's not uncommon to lose up to 30 percent of committed buyers once the final occupancy permit is awarded. A case in point is the John Ross, which had 222 committed buyers in 2005 willing to provide \$15,000 to \$30,000 in earnest money deposits. By the late spring 2008, the building had only closed on 177 units.⁴ So far in 2008 there have only been five recorded sales in the John Ross.⁵

| Central Portland Completions by Year (New Const.) | |
|--|--------------|
| 2006 | 766 |
| 2007 | 1,473 |
| 2008 | 610 |
| Total | 2,849 |

(1) As Expected, Sales are Down in 2008

Although 2007 sales were at record levels, they fell short of filling the inventory that recently came on-line. Through September of this year, 2008 has only had 744 sales. If one assumes no additional slowing from the recent housing and credit market turmoil, trending this sales rate through to December, 2008 would result in projected yearly sales of 992 units. This would be comparable to the 995 sales that occurred in 2004. The major difference is that in the years 1992 through 2003, central Portland did not see more than 300 condominiums delivered in any given year. This rate of sales, however, has not kept pace with the inventory that has been added in recent years. Also, as the Portland condominium market has matured, there are increasing numbers of units being resold in existing buildings. These additional listings, which may be in superior locations to new buildings, only increase the competition.

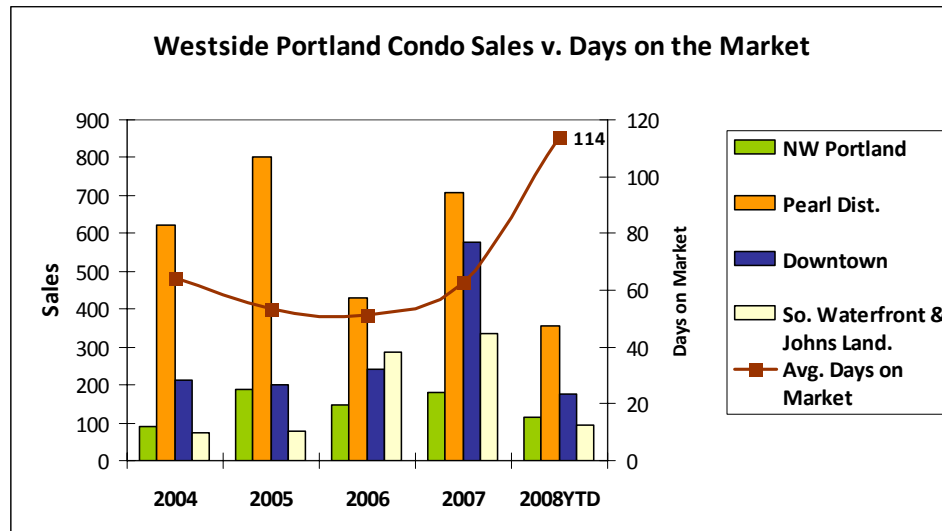
(2) It Is Taking Longer to Sell Condominiums, 80 Percent Longer

Residential sales in general are taking longer these days. However, condominiums are spending more time on the market when compared to detached housing on Portland's west side. The latest figures from RMLS⁶ show that condominiums in the four west side submarkets for 2008 needed an average of 114 days to sell, whereas detached homes are averaging 67 marketing days. The graph below shows condominium sales between 2004 and the present. The current market time of 114 days over last year's 63 days represents an increase over 80 percent. 2001 ended the year with condominiums averaging 120 days on the market before sale. At the time, the U.S. was just beginning an economic downturn and Portland was feeling the pain a little more than other areas of the country due to the region's close ties with the high tech industry. Comparing the current condominium market with the 2001 market is a bit of an apples to oranges comparison. The high-end condominium market in 2001 numbered less than 900 units and the South Waterfront was more likely to be associated with dormant industrial activity. Now, the Pearl and other areas of downtown have seen complementary retail development, offering a greater sense of place. This, of course, makes the dramatic increase in marketing days a red flag for difficulty in the condo market.

⁴ Manning, Jeff, "Builders Heated on Buyers Cold Feet", The Oregonian, November 26, 2007.

⁵ Source: MetroScan

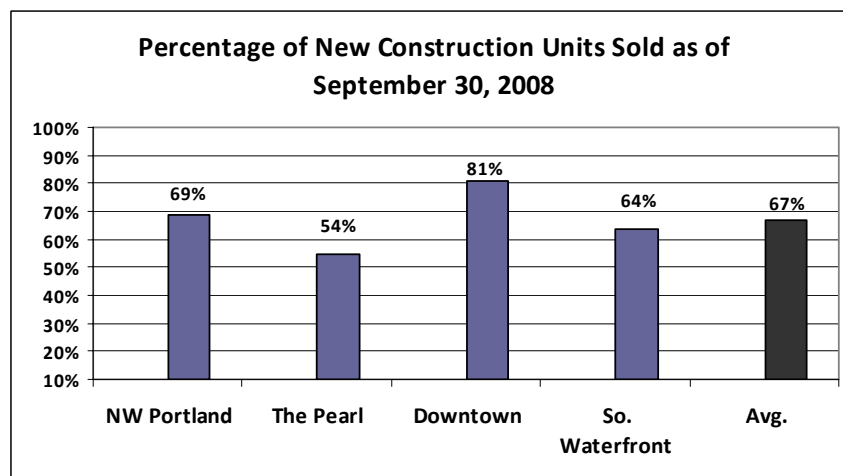
⁶ RMLS, accessed on October 6, 2008.



(3) Inventory Remains High

The rate of sales in 2008 has dropped noticeably when compared to past years. Due to the new inventory added last year, 2008 sales would at least have to compare with those of 2007. That has not happened so far. The Oregonian recently reported that there are currently 884 unsold units in the new central city towers that have been completed since 2006.⁷ This figure equates to 67 percent sales rates for new condo units recently constructed.⁸

The table below shows the percentage of absorption for new tower construction by submarket. Downtown leads the way with an absorption rate of 81 percent, but this submarket largely benefited from completing a bulk of units from 2006 through mid 2007. Clearly, buildings getting to the market later are struggling with sales.

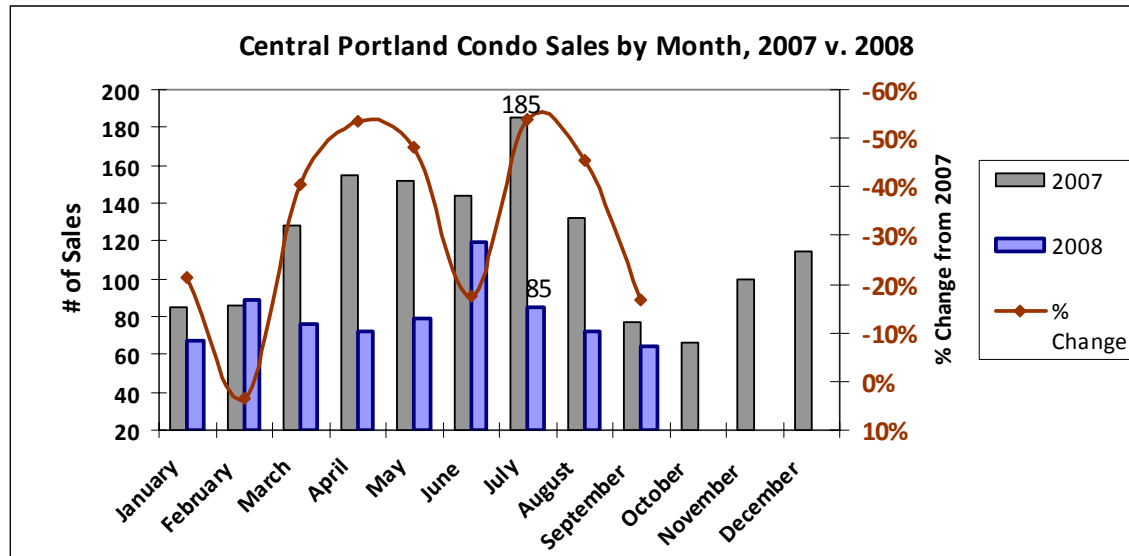


The figures above only pertain to units sold from new construction. In accessing the absorption rate for all condos in the four central submarkets, it is helpful to look at the pace of home sales for 2008 in comparison to 2007. The following chart of monthly condo sales

⁷ Frank, Ryan, "Portland's Condo Craze Comes to Screeching Halt", The Oregonian, October 10, 2008.

⁸ Source: Realty Trust City. Figures include pre-sales for The 937 and The Encore in the Pearl.

illustrates the difficulty condominiums this year have had in duplicating 2007 sales. With high levels of inventory, the central Portland market has only averaged 80 sales per month, down 33 percent from last year's average of 119 sales per month. Only one month, February, saw more sales in 2008 than 2007, and that was by just three sales. Conversely, July, typically a strong month for residential sales recorded only 85 sales this year — one hundred sales fewer than were recorded for the same month in 2007.



*Source: RMLS monthly sales reports

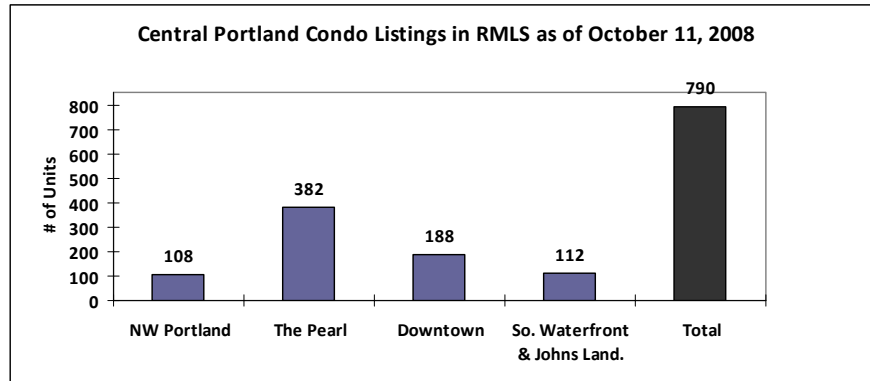
As the Oregonian reported, the new construction towers have only averaged 14 sales per month for the third quarter of 2008.⁹ This rate of sales is not expected to stay constant, and the recent turmoil in the world economy may be expected to suppress sales in the near term. Aside from the 884 newly constructed units for sale, RMLS reports that the central west side currently has 790 condominiums listed for sale.¹⁰ While the RMLS figure captures nearly all of the resale market, it does not report all new construction listings. Buildings with a large number of unsold units usually list a fraction of units for sale.

With the recent turmoil in the national economy and the uncertainties hanging over the housing and lending markets, it is difficult to estimate when housing prices will bottom out. Sales prices so far for 2008 have shown little depreciation. In fact, both the average and median sales prices for condominiums in the central Portland market have increased. Yet, much of this increase is based on the fact that the average size of condominium units has increased over recent years. What the data do show is that the average and median price per square foot is no longer increasing in 2008 in comparison to last year. The price per square foot, however, has only gone down 0.7%.¹¹ Considering the size of the current inventory and the striking increase in days-on-the market it appears that many building owners are reluctant to decrease asking prices.

⁹ Frank, Ryan, "Portland's Condo Craze...", October 10, 2008.

¹⁰ Accessed on October 11, 2008.

¹¹ Figure computed taking a weighted average of the change in price/square foot between 2007 and 2008 from sales figures gathered for the four central downtown submarkets.



Another factor is the shadow market, or condominium units that are now being rented. Jeff Gibbs, a multifamily broker with Norris & Stevens, reported that apartment management companies are marketing more condominiums than expected. The current estimate from Norris & Stevens is that there are "800 or so" such shadow units on the market.^{12[1]} The figure was largely calculated through interviews with management companies marketing condominiums as rentals for investors. Trammell Crow Residential (TCR) has also been tracking the condominium shadow market for the last year and a half through weekly market surveys. TCR has been selective with condominium construction in Portland in recent years delivering only the Vaux, a 145-unit project in the northwest neighborhood in 2006. Instead, TCR has focused on apartments with several projects being built in the metro area, including two high-end rental buildings in Portland (Tupelo Alley on North Mississippi (188 units) and the Alexan (294 units) on the South Waterfront).

Based on weekly listings observed on Craigslist, Noel Johnson, a development associate with TCR, estimates that there are currently between 500 – 700 shadow units within the downtown market. Although many of these shadow units are not being actively marketed as rentals, they have to be considered as part of shadow inventory since the owners most likely did not intend to become landlords. With that said, combining the current stock of unsold new construction (884) and 60 percent of the current RMLS listings (474), and approximately 600 shadow units leaves an estimated 1,958 condominiums for sale in the Portland central west side market. Making an optimistic assumption that sales will measure between 60 and 100 units per month in the future leaves between 20 and 33 months of inventory. If the residential market finds a bottom in 2009, the rate of sales would be expected to pick up. Should residential values continue to depreciate into 2010 condominium inventory could have a slow and painful workout.

(4) Finding Qualified Buyers May Only Be Half the Problem

The residential real estate market has experienced tightening lending standards due to the fallout from troubles stemming from the subprime mortgage market. Today buyers looking to purchase need to bring a minimum of between five percent to ten percent equity before being approved for a mortgage.¹³ The days of income-stated and no-money-down loans have long passed. With higher lender standards, the pool of possible buyers has shrunk noticeably. Also, with many new condominium units averaging over \$450,000, those not able to bring a large down payment will have to obtain a jumbo loan¹⁴, which carries a higher interest rate. As

^{12[1]} Gibbs, Jeff, "The Shadow Market", Norris & Stevens Apartment Investor Journal, Summer 2008.

¹³ There are still some 3 percent down programs available for conforming loan amounts. So, as long as the loan amount is below \$417,000, the loan to value can be as high as 97 percent.

¹⁴ Jumbo Loan: A home loan that exceeds the limits set by Fannie Mae and Freddie Mac (the 2007 limit is \$417,000 in the continental U.S.)

of mid-October 2008, 30-year fixed jumbo loans were averaging 7.31 percent.¹⁵ This is over one percentage point higher than the average rate of 6.06 percent for a fixed jumbo loan in 2006.¹⁶ The difference between the two rates would be an extra \$350 per month for a \$420,000 loan. As interest rates continue to rise, there will be downward pressure on asking prices.

Despite the smaller pool of qualified buyers, a much larger problem looms for owners of new or converted condominium projects. According to Katrina Hughes, Vice President of Sales for Flagstar Bank who specializes in finding loans for downtown condominium buyers, the Freddie Mac and Fannie Mae pre-sale requirements have become standard. Ms. Hughes reports that these stricter lending standards have been driven in large part by the insurers for the mortgage companies. Now it is extremely challenging to place a loan for a unit in a condominium project that is not at least 50 percent sold or under contract and does not have an established relationship with a preferred lender. In the past, the rules had been relaxed, which allowed lenders to loan on mortgages contained in buildings that were even less than 25 percent pre-sold. This, ironically, was not much of a problem from 2004 through 2006 when buyers were bidding for the chance to own a condominium in the Pearl long before construction completion. Now, with the current obvious problems in the market, lenders will not do anything to jeopardize loans from being sold on the secondary market.

The change in lending requirements presents of large hurdle for condominium developers. Buildings that are well short of the 50 percent pre-sale requirement will find it difficult to match the sales rates of past. Even if there are qualified buyers interested in purchasing, they will be forced to wait for other buyers to come on-board. As more time has passes, prices will most likely continue to decrease. The only alternatives at that point would be foreclosure or to find another source of equity, further decreasing the developers profits.

Some of the larger condominium projects have been able to avoid this requirement by directing financing through a preferred lender. Representatives of Realty Trust report that Atwater Place in the South Waterfront is not having any difficulty arranging financing for buyers through their preferred lender, JP Morgan Chase, even though the building is currently less than 50 percent sold. Essentially, these banks have elected to keep the financing loans on their balance sheets until the building reaches the 50 percent presold requirement.

For those developers not able to land a preferred lender willing to avoid the 50 percent pre-sale requirement, a glimmer of hope surfaced through the RMLS sales reports, which show that a greater proportion of condominium buyers purchase with cash. Out of 691 west side condominium sales tracked by RMLS this year, 182 sales (26 percent) were purchased with cash at an average price of \$578,000. The same report showed that only 15 percent of homes on the west side were purchased in this fashion. The significance on the current rate of sales is not known, but the difference most likely relates to the demographics of those purchasing condominiums in Portland. Such cash buyers could fall into two categories: (1) those that sold a higher priced home, like empty nesters or buyers from Washington or California; (2) those with the ability to purchase as an investment or second home.

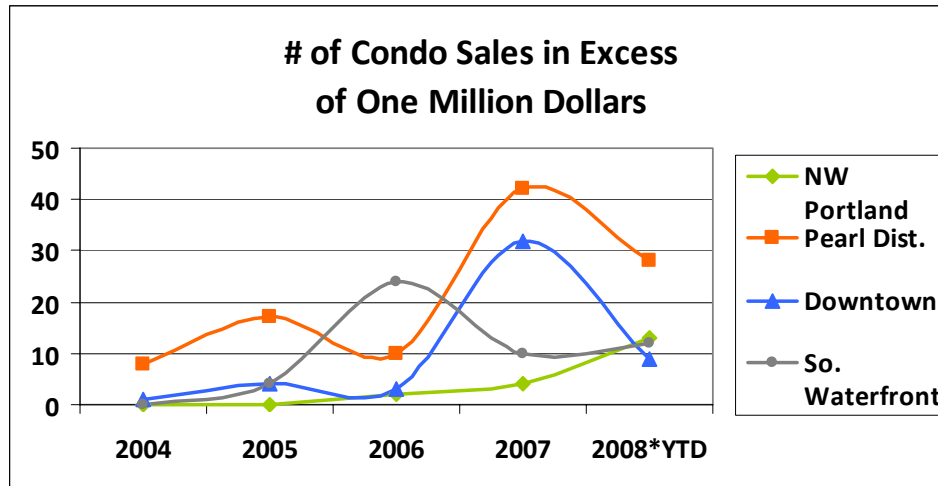
(5) Million Dollar Sales? The Buying Continues

The 2007 analysis reported that purchases of condominiums over one million dollars had leveled off and declined in some areas. This was certainly true for the South Waterfront, which saw 24 sales over one million dollars in 2006, and only 10 sales above one million dollars in

¹⁵ Bankrate.com, "30-year Rates on Jumbo Mortgages Go Up in the United States on Thursday," http://www.bankrate.com/brm/updates/ybir/ybir_state.asp?prodInit=M&prodid=4, accessed on October 9, 2008.

¹⁶ Federal Housing Finance Board, <http://www.fhfb.gov/GetFile.aspx?FileID=6520>, accessed on October 9, 2008.

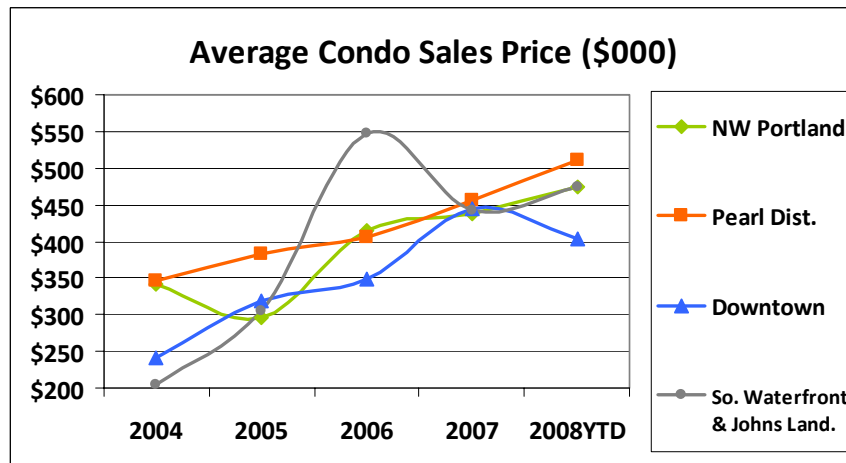
2007. Over in the Pearl, however, million-dollar sales surged in the later half of 2007, where 34 such sales closed between August 1 and December 31, 2007. With the addition of the downtown data, there were 88 sales in excess of one million dollars in 2007. So far, the first nine months of 2008 has seen 62 sales close north of one million dollars, with nearly half of these sales for units in the Pearl.



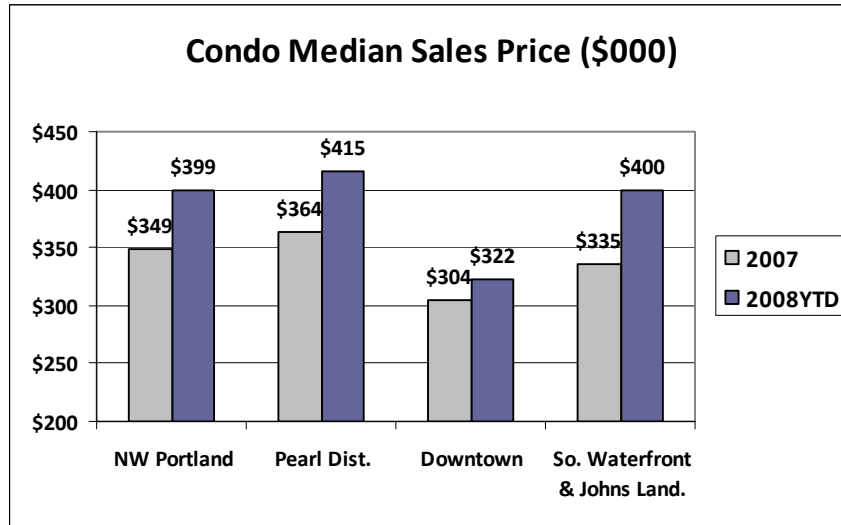
At this point it appears that million dollar condominium sales in 2008 will come close to keeping pace with 2007. The only exception will be downtown where no new construction units will be coming onto the market. The Pearl will see the 114-unit 937 completed this month and the 177-unit Encore opening at the start of 2009. However, based on reports from brokers familiar with these projects both buildings have pre-sold fewer than 25 percent of their units. This is a striking departure from 2006, and even early 2007, when newly completed projects opened nearly 100 percent sold out.

(6) Average Sales Price and Median Sales Price Continue to Climb

With the exception of the downtown submarket, the average and median prices for condominiums in the Pearl, the South Waterfront and Northwest Portland continue to climb. In 2007 the average sale price for all four submarkets was separated by only \$19,000, ranging from an average price in Northwest of \$437,000 to \$456,000 in the Pearl. In 2008, average sales prices for the four submarkets have shown greater variability. This year the average sale price in downtown retreated to \$403,000, while the Pearl's average price has climbed over \$511,000.

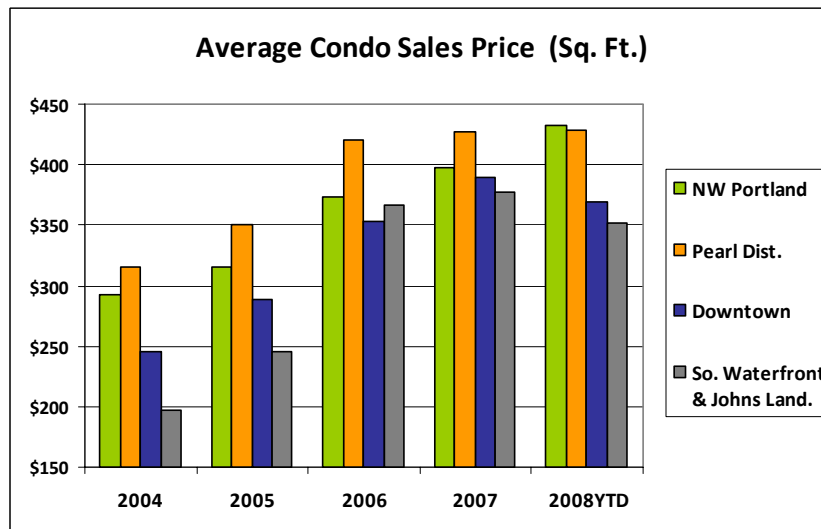


As with the average sales price, the median price increased in 2008 for all four submarkets. The median sales price for these markets climbed to \$384,000 from \$338,000 in 2007, an increase of almost 13.5 percent. Again, the Pearl District leads the way with a median price of \$415,000.



(7) Sales Price Per Square Foot Levels Off

Data from 2008 shows that the price paid per square foot has leveled off or declined in three of the four submarkets profiled. Yet, the average and median price for condominiums sold in 2008 continued to increase. With a decrease in square footage price, how do the average and median sales prices continue to increase? The most recent sales data for 2008 reveal that the average and median size of condominiums sold in all submarkets has increased. Newer developments have been built with larger units. In 2008 the average and median square footage of a condominium in the four submarkets was 1,180 square feet and 1,060 square feet, respectively. This represented an increase of 16 percent for average size and over 21 percent for median size when compared to 2007 figures.

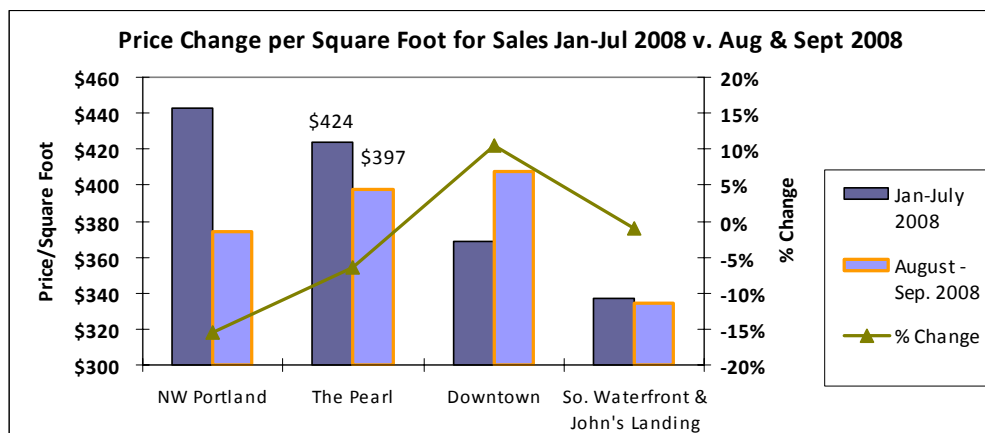


Northwest Portland was the only submarket of the four that did not see a leveling off or decline in price per square foot. Northwest Portland's square footage price increase was undoubtedly helped by the addition of the Westerly, a 104-unit building that opened in March with prices ranging from \$350 to over \$940 per square foot. Since yearly condominium sales in Northwest Portland have not exceeded 200 in any year, the effect of the Westerly's 36 recorded sales is more pronounced. The drop in square footage prices for the other three submarkets hints that owners are willing to discount to facilitate sales.

The chart below shows the increase in median square footage for units sold in the four submarkets from 2007 to 2008. The current drop in square footage price is illustrated by the right side of the table. Taking 2007 median square footage price for each submarket and multiplying by the 2008 median size shows that prices would have exceeded the reported 2008 median price. Therefore, although the median price has increased in 2008, the price per square foot tells us that the increases may not be as dramatic as they appear.

| Median Condo Size (Square Feet) | | | | 2008 2007 | Size at Median | Median 2008 Price |
|---|------------|--------------|-------|------------------|-------------------|-------------------------|
| | 2007 | 2008YTD | Diff. | \$/Square Foot | | |
| NW Portland | 938 | 1,034 | 96 | \$409,464 | | \$399,000 |
| Pearl Dist. | 886 | 1,040 | 154 | \$429,520 | | \$415,000 |
| Downtown | 773 | 879 | 106 | \$343,689 | | \$322,000 |
| So. Waterfront/Johns Landing | 896 | 1,286 | 390 | \$489,966 | | \$400,000 |
| Average | 873 | 1,060 | 187 | | | |

Recent sales for August and September show that sales price per square foot has decreased when compared to the first seven months of the year for three of the four central submarkets. This comparison should be considered with caution since the August and September sales contained only 136 sales for the four submarkets combined. Despite the caution, it is remarkable that the Pearl district, with 62 sales in the August and September, 2008, saw the average price per square foot drop by \$27.



Conclusion

Although 2007 recorded the largest number of condominium sales of any year in Portland, the addition of nearly 1,500 units in 2007 placed considerable pressure on the market. With the trouble in residential real estate and the recent downturn in the economy, 2008 condominium sales have not kept pace with the rate of construction. If the current rate of sales holds steady, the four major central downtown submarkets combined will be close to 950 sales, or about 850 fewer sales less than last year. Historically, this figure appears on par with the sales recorded for 2004 through 2006, but considering the number of current listings and the increased inventory, sales have fallen below developers' expectations. Even more remarkable is the extraction of over 1,400 condominium units from the construction pipeline that will be converted to luxury apartments. Had even half of these condominiums been completed as planned, Portland would rival other underperforming condominium markets like Miami, Las Vegas and Phoenix.

While the average sale price of condominiums sold in 2008 has eclipsed that of 2007, three of the four central downtown submarkets report a decrease in the average price per square foot. Analysis of sales over the last two months suggests that the rate of price depreciation is accelerating, which is consistent with the detached housing market in Portland. Considering the current rate of sales and the number of listings, condominium inventory is estimated at a minimum of 20 to 33 months. This is significantly higher than overall residential inventory for Portland, which is estimated at ten months.

Luxury Apartments: Challenging the Market

Greg LeBlanc, MBA, RMLS Fellow, & Certificate of Real Estate Development Student



Opus Northwest's Ladd Tower nears completion on the downtown Park blocks with Gerding Edlen's Cyan rising in the right foreground.

Starting in the spring of this year, Portland began to add an unprecedented number of luxury apartments to the rental stock, with rents averaging \$2.25 a square foot. For a typical 750-square foot one bedroom this equates to a rent payment of nearly \$1,700, more than most metropolitan homeowners pay for a mortgage.

Since May of this year, 865 luxury units have been added with four different buildings. In the next eleven months, eight additional luxury rental buildings will be completed adding 1,828 units, which will double the amount of high-end rental supply in the city. Over half of these units will come from buildings that were originally conceived as condominium projects, but opted to revert to apartments due to sluggish sales. Earlier in the year this appeared to be a sound choice, but with economic troubles now traveling well beyond the housing sector, there is concern that luxury buildings will have difficulty achieving stabilized occupancy in the next two years. In an ominous sign, the four luxury buildings now open are all offering concessions, and rent growth has come to a staggering halt in the regional rental market after nearly two years of increases. This report analyzes Portland's high-end market and the challenges it will face in the near future.

I. Inventory Location

Between May 2008 and August 2009, over 2,600 new luxury rental apartments from twelve projects will enter the central Portland market. The chart below identifies these projects, which are spread between North Mississippi, the Pearl District, downtown, close-in Southeast and the South Waterfront. Asking rents for these projects will average \$2.25 per square foot, over \$.30 more than the average rent for existing top-end rental units downtown.

| Building | Location | Units | Avg.Asking Rent | Anticipated Completion | Developer/Owner |
|-------------------------------|----------|--------------|-----------------|------------------------|---------------------|
| The Harrison | Downtown | 188 | \$2.02 | complete | Bean/W&D/Reliance |
| Ladd Tower | Downtown | 332 | \$2.40 | Feb-09 | Opus Northwest |
| 12 th & Washington | Downtown | 274 | \$2.40 | Jun-09 | Gerding Edlen |
| Cyan | Downtown | 354 | \$2.25 | Apr-09 | Gerding Edlen |
| Tupelo Alley | N Pdx | 188 | \$1.75 | Jun-09 | TCR |
| PARK19 | NW | 101 | \$2.50 | May-09 | Opus Northwest |
| Wyatt | Pearl | 245 | \$2.33 | complete | Sobrato |
| Asa | Pearl | 234 | \$2.40 | Nov-08 | Unico |
| 2121 Belmont | SE Pdx | 109 | \$2.00 | complete | Williams & Dame |
| 20 th & Hawthorne | SE Pdx | 51 | \$2.25 | Aug-09 | Gerd. Edlen/Metzler |
| The Ardea | SoWa | 323 | \$2.40 | complete | Gerding Edlen |
| Alexan | SoWa | 294 | \$2.30 | Jun-09 | TCR |
| The Matisse | SoWa | 272 | \$2.30 | Oct-10 | Simpson Housing |
| Total | | 2,965 | \$2.25 | | |


The addition of these new luxury units will increase central Portland's high-end rental supply by almost two-and-a-half times. Analysis of the central Portland rental stock completed by using figures from the Portland Development Commission's October 2005 Central Portland Housing Inventory study¹, and estimating additional housing units added to the urban core since 2005, shows that there are 23,500 of combined ownership and rental units in Portland's urban core.











As a word of caution, consideration for housing units added since the PDC study may not have captured many smaller in-fill projects that occurred throughout the last three years. For this reason, the analysis presented herein should be considered as approximate figures.² Of the 23,500 housing units between close-in North Portland and Southeast Portland, the Pearl District, downtown and the South Waterfront units, it is estimated that 70.6% are rentals and 29.4% are owned. These percentages have been adjusted to include 551 units converted from rentals to condominiums in 2006³ and 2,869 condominium units added between 2006 and the present.

¹ Portland Development Commission, http://www.pdc.us/pdf/housing_services/pubs/central_city_inventory_200510.pdf

² The PDC reports that the 2008 Central City Housing Inventory has been delayed, but hopes to release an updated study by the end of the year.

³ Source: Kathleen Buono, Integra Realty Resources. Conversion figures for 2007 not available.



| | |
|--|---|
| | <p><u>Tupelo Alley</u> 188 units 3810 N. Mississippi TCR Development</p>  |
| | <p><u>The Wyatt</u> 245 Units 1125 NW 12th Ave. Sobrato Dev. Co.</p>  |
| | <p><u>The Asa</u> 234 units 1233 NW Lovejoy Unico</p>  |
| | <p><u>2121 Belmont</u> 109 units 2121 SE Belmont Williams & Dame</p>  |
| | <p><u>PARK19</u> 101 Units NW 19th Ave. & Hoyt Opus Northwest</p>  |
| | <p><u>SE 20th Ave. & Hawthorne</u> 51 units 1550 SE 20th Ave. Gerding Edlen/Metzler</p>  |
| | <p><u>Harrison Tower</u> 188 Units 222 SW Harrison St. W&D/Reliance</p>  |
| | <p><u>The Alexan</u> 294 Units 0650 SW Gains TCR Development</p>  |
| | <p><u>The Ardea</u> 323 Units 3720 SW Bond Ave. Gerding Edlen</p>  |
| | <p><u>The Matisse</u> 272 Units 4033 SW Bond. Simpson Housing</p>  |
| | <p><u>12th & Washington</u> 274 Units 1221 SW Washington Gerding Edlen</p>  |
| | <p><u>Ladd Tower</u> 332 Units 1300 SW Park Ave. Opus Northwest</p>  |
| | <p><u>The Cyan</u> 354 Units 333 SW Harrison St. Gerding Edlen</p>  |

The number of rental units in the central core, based on the above analysis, is estimated at 16,591. Of this number, only 11.7%, or 1,928 units, are considered high-end rental units for the purpose of this study.⁴ As we see from the table below, the average asking rent for the eleven properties making up the existing luxury stock is \$1.92 per square foot, or \$.33 per square foot less than the average for new luxury units recently added and those scheduled to come to the market in the next year.

| Existing Luxury Rentals | | | | | | | |
|--------------------------------|-----------------|--------------|-------------------|---------------|---------------------|-------------------|-----------------------|
| Building | location | Units | rent range | | rent average | completion | Avg. Unit size |
| | | | low | high | | | |
| Louisa | Pearl | 242 | \$1.73 | \$2.79 | \$2.23 | 2005 | 928 |
| 10 th @ Hoyt | Pearl | 178 | \$1.84 | \$2.46 | \$2.13 | 2004 | 732 |
| Burlington Tower | Pearl | 155 | \$1.97 | \$2.73 | \$2.16 | 2004 | 916 |
| Kearney Plaza | Pearl | 131 | \$1.71 | \$2.24 | \$1.99 | 2000 | 701 |
| Honeyman Hardware Lofts | Pearl | 106 | \$0.97 | \$2.00 | \$1.38 | 1993 | |
| Village at Lovejoy | Downtown | 199 | \$1.19 | \$1.62 | \$1.42 | 1999 | 859 |
| Museum Place | Downtown | 98 | \$1.56 | \$2.50 | \$2.09 | 2003 | 754 |
| Southpark Square | Downtown | 191 | \$1.71 | \$2.59 | \$2.09 | 1988 | 839 |
| The Vue | Downtown | 307 | \$1.70 | \$2.40 | \$2.02 | 1951 | 674 |
| Essex House | Downtown | 156 | \$1.66 | \$2.33 | \$1.99 | 1992 | 759 |
| Riverplace Apt. | Downtown | 185 | \$1.29 | \$1.85 | \$1.67 | 1991 | 1021 |
| Sum/Average | | 1948 | \$1.58 | \$2.32 | \$1.92 | | 818 |

Of the units mentioned above, buildings constructed since 2000 are considered to be the most comparable to the new luxury buildings entering the market. These buildings, The Louisa, 10th @ Hoyt, Burlington Tower, Kearney Plaza and Museum Place have updated finishes, in-unit washer/dryers, ample parking and are in high demand locations. All of these buildings are reportedly at 95% or above in occupancy at this time.

With the addition of the 865 units completed since May of this year and the 1,828 units that will be completed in the next eleven months, the supply of central high-end rental units will increase from 11.7% to 24%. Phoenix developer Alliance Residential, will start construction in November of another 152-unit luxury rental complex at NW 14th and Lovejoy to be called the Broadstone Enso, scheduled for completion in the first quarter of 2010. Denver based Simpson Housing will also start soon on the 272-unit Matisse on the South Waterfront, which will mean that the Portland luxury market will add 3,117 units between early 2008 and late 2010.

This dramatic increase in luxury supply represents an unprecedented addition of new units in this rental class. Looking at the numbers of luxury rental units that have come to the market over the last ten years, we see that only one year, 2004, saw more than 300 units delivered in a single year.

⁴ Information on existing high-end rentals provided by Crispin Argento, Research Analyst for Colliers International, Portland. This is not meant to be an exhaustive list of all high-end rentals in the downtown core, but it is thought to comprise most of the high-end market for rental buildings containing at least 50 units. Other areas, like Northwest Portland, contain high end units but are not considered since they are not comparable to the larger scale luxury developments now being added to the market.

The next year and a half will be extremely competitive for high-end buildings to attract renters. Already we are seeing concessions offered by all four luxury buildings that have entered the market this year. Concessions have ranged from the Ardea's matching concessions offered by competing buildings to over two months of free rent at both Harrison Towers and the Wyatt. While concessions are common with larger multifamily developments, the race for lease-up appears to be off and running between all the newly completed buildings. The 234-unit Asa, located across the street from the Wyatt in the Pearl, will become the fifth luxury building completed this year when it opens its doors to renters on November 15, 2008. So far, the management company for the Asa, Riverstone HSC, reports that it has not needed to offer any concessions as it claims that leasing has exceeded its goals.

The question remains how long it will take to absorb the new luxury units. Interviews with Opus Northwest and Gerding-Edlen reveal that their proformas are projecting leasing between 18 and 25 units per month. For the larger buildings like the Ardea and Ladd Tower, this would equate to approximately a year and half to reach stabilized occupancy. Whether or not these lease-up rates are attainable is an open question. The volume of luxury apartments entering the market is new to Portland. The current supply of luxury units in Portland, aside from the four projects completed since May 2008, is at 95% occupancy or higher.

There are also only a few comparable developments to look to when considering absorption. The table below details absorption for five of the most recent high-end rental buildings completed in Portland before 2008. Four of the buildings are in the Pearl, and the other, Museum Place, is on the west side of downtown. All of these projects are located in areas that have seen considerable condominium development in the last seven years.

| Building | Units | Date of Completion | Date of Stabilized Occupancy | Total months for Stabilized Occupancy | Average Unit Absorbt./Month |
|-------------------------|--------------|---------------------------|-------------------------------------|--|------------------------------------|
| Kearny Plaza | 131 | Sep-00 | Mar-01 | 7 | 19.6 |
| Museum Place | 140 | Jul-03 | Dec-04 | 18 | 13.0 |
| 10 th @ Hoyt | 178 | Feb-04 | Apr-05 | 14 | 17.0 |
| Burlington Tower | 155 | Dec-04 | Apr-06 | 16 | 9.7 |
| The Louisa | 242 | Feb-05 | Jan-06 | 11 | 22.0 |
| Total Units | 846 | | Average | 13 | 16 |
| | | | Median | 14 | 17 |

*Source: Kathleen Buono, Sr. Analyst, Integra Realty Resources.

Based on these historical figures, only two buildings, the Louisa and Kearney Plaza, have absorbed an average more than 18 units per month. When these buildings were completed, however, the urban core was in the midst of "condominium fever" where many Pearl District condominium developments were coming close to achieving 100% pre-sale commitments before receiving final plat approval from Multnomah County. That atmosphere has changed since the few remaining condominium developments that have not converted to luxury rentals are struggling to find buyers.

Due to the tightening lending standards and falling home prices, the demand for condominium units in the urban core has dropped considerably. Does this mean that demand to live within the urban core has also declined? Based on current vacancy numbers, this does not appear to be the case.

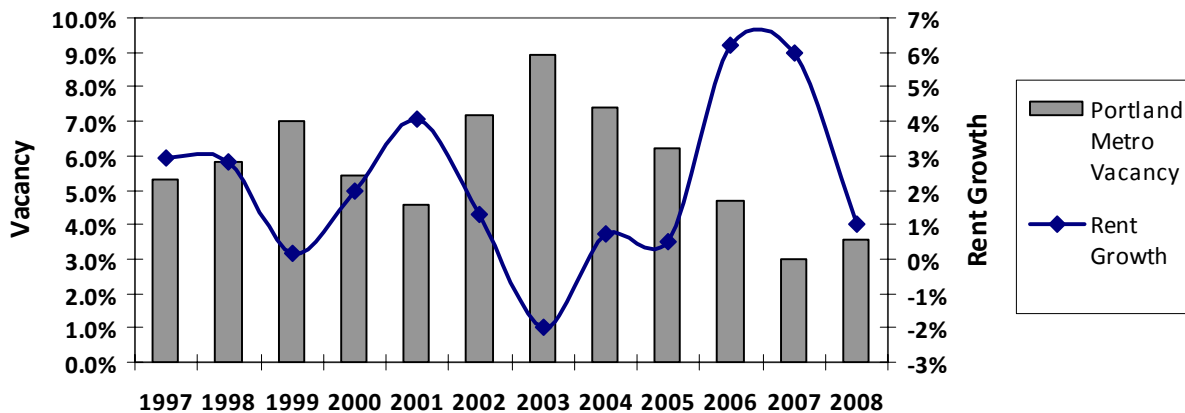
II. Current Status of Multifamily in Portland

Vacancy rates for the Portland area are low, registering at 3.58% for the September 2008 survey completed by the Metropolitan Multifamily Housing Association. Although the current vacancy rate is low, 14 of 20 submarkets surveyed by MMHA reported vacancy increases. Areas with the highest increases were outlying suburban areas, where east Vancouver registered 8.3% vacancy and Hillsboro reported 6.22% vacancy. Downtown Portland's vacancy of 3.15% continues to remain slightly below the metro average.

The last two MMHA rental surveys completed in April 2008 and October 2007 reported a market-wide vacancy of 3.3% and 2.9%, respectively. These increases in vacancy rates are relatively modest, but they do show that rates are starting to accelerate again after a downward trend between 2003 and 2007. A more startling indicator is the drop in the rate of rent growth.

The current economic climate has clearly affected the ability of landlords to raise rents even though the current vacancy rates are hovering at decade lows. The inflation over the summer with \$4.00+ gasoline and increasing unemployment has many multifamily owners concerned. Steve Davis, a vice president for multifamily management company Riverstone HSC, summed up the situation by stating many owners would gladly take 95% occupancy and zero rent growth over the next year and a half if they had the offer.

Portland Metro Vacancy v. Rent Growth



*Source: Mark D. Barry & Associates and Hendricks & Partners

Developers delivering high-end rental projects will have to contend with this environment. Just eight months ago, the rental market had more optimistic expectations. Due to the rise in home prices, multifamily development remained in check as developers focused on ownership housing. Between 2003 and 2007 the metropolitan Portland area only averaged between 3,500 and 4,500 multifamily units developed per year.⁵ During this same time period, the area built over 8,000 new single-family homes.⁶ Although credit was relatively easy to obtain, the steep increase in home prices prevented many renters from buying homes in recent years. Now, even with prices depreciating 7.3% in the last year,⁷ tighter lending standards act as another barrier to homeownership.

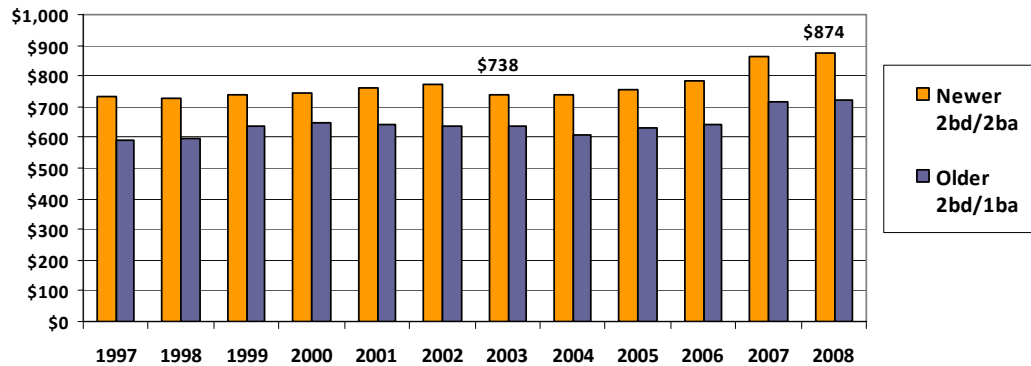
⁵ Hendricks & Partners, Apartment Update 2008, First Quarter.

⁶ Mark Barry, MAI, Metro multifamily Housing Association Apartment Report, fall 2008.

⁷ Ibid.

The slowdown in the single-family market worked favorably for the multifamily market, which was able to push 5% to 10% increases in rents in 2006 through to the first half of 2008. The current market and the world economy have changed for the worse. Unemployment is rising and challenges the rental market, as evidenced by increasing late rent payments.

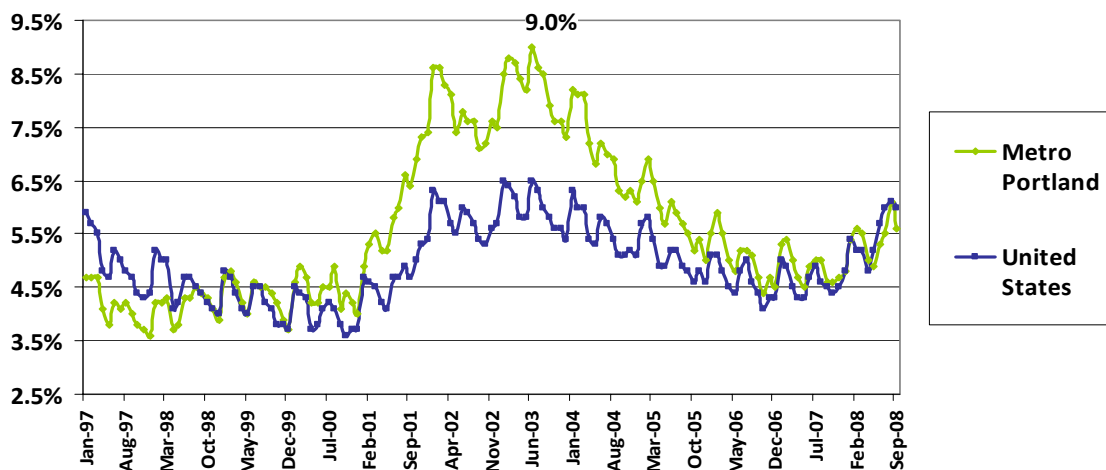
Average Portland Metro Rents



*Source: Norris & Stevens Apartment Investors Journal, Summer 2008

Looking back at the last recession in 2001 and 2002 the metropolitan area, and the high-tech industry in particular, felt the downturn stronger than many other areas of the country. It was not until late 2005 that the region's unemployment rate fell in line with the nation's overall unemployment rate. Most recent data from September 2008 shows that metropolitan Portland's unemployment rate has increased to 5.6%, a gain of 1% over last October.⁸ Portland seems to be weathering the downturn better than many other areas of the country and is still below the national unemployment rate of 6.1%.

Unemployment: Metro Portland v. United States



Source: Oregon Employment Department

The Portland area has also fared better than other areas of the West, which saw record levels of single-family home inventory come on the market. Given the enormity of economic problems that have surfaced in the world economy, most local economists predict that the market will be especially difficult for the next 12 to 24 months. However, the Portland region now appears

⁸ Oregon Employment Department

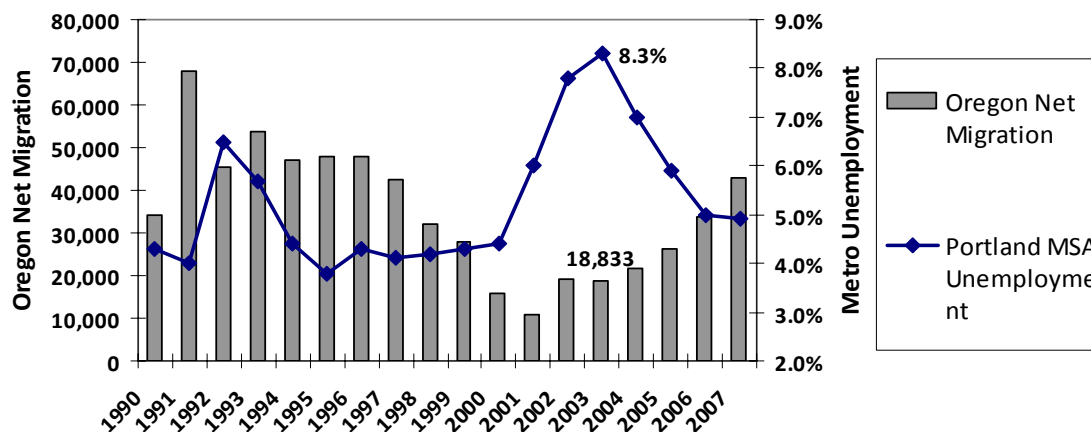
better positioned than in 2001. The metropolitan area has attracted many new sustainable energy companies eager to take advantage of the Business Energy Tax Credit (BETC), which provides large incentives for companies investing in clean energy. Companies like Vestas (500 employees) and SolarWorld (1,000 planned employees by 2011), have opened manufacturing facilities in the region in recent years. This helps offset the loss of Freightliner, which elected to wind down operations (900 jobs) at its Swan Island manufacturing facility by 2010.

What effect will a downturn in the economy have on the luxury rental market? Jack Goodman, president of Hartrey Advisors and former chief economist for the National Multi-Housing Council who has studied apartment performance during challenging and prosperous economic times, did a comprehensive analysis in a 2003 study.⁹ Mr. Goodman's study concluded that high-end apartments outperformed other apartment classes when multifamily grew briskly, but underperformed when the market slowed down.

Reasons cited by Mr. Goodman were that strong economic growth improved purchasing power for luxury residents. Prosperous times also allow Class B tenants to move into Class A properties. When the market turns, however, demand for high-end units drops disproportionately because this segment is more dependent on demand from job transferees and new hires.

Although Mr. Goodman's research depended on data obtained from the American Housing Surveys from 1989 to 1991 (recession) and 1997 to 1999 (growth), discussions with owners and managers of high-end projects in Portland confirm that the luxury segment still relies heavily on job transferees and new hires. In separate interviews of the Asa on-site manager, Heather Ostergard from Riverstone HSC, and Alan Jones, development manager for Gerding-Edlen's Ardea, both estimated that 25 percent of all applicants were from outside the Portland region.

Oregon Net Migration and Metro Unemployment



*Source: Oregon Employment Department and Portland State University Population Research Center

Based on the research of Mr. Goodman and reports from luxury rental managers, the region's near-term economic performance will play a large role in the successful lease up of the projects coming online. It appears that economic growth is a strong indicator of attracting new

⁹ Goodman, Jack, "Apartment Performance in Good Times and Bad", Hartrey Advisors and the Real Estate Research Group, May 6, 2003, http://hartrey.com/GoodmanRERI_May2003.pdf

residents to the area. From the graph above we see that net migration into Oregon receded during the 2001 – 2003 recession and only recently returned to levels seen during the 1990s.

We have all heard about the disproportionate in-migration of the coveted urban creative class of 25 to 34-year old, college-educated people described by the 2004 study completed by Impresa Inc. and Coletta and Company.¹⁰ This cohort is thought to be highly desirable age group because they are highly educated and at the start of their careers. As time goes on, this group matures, builds careers, starts a family and puts down roots.

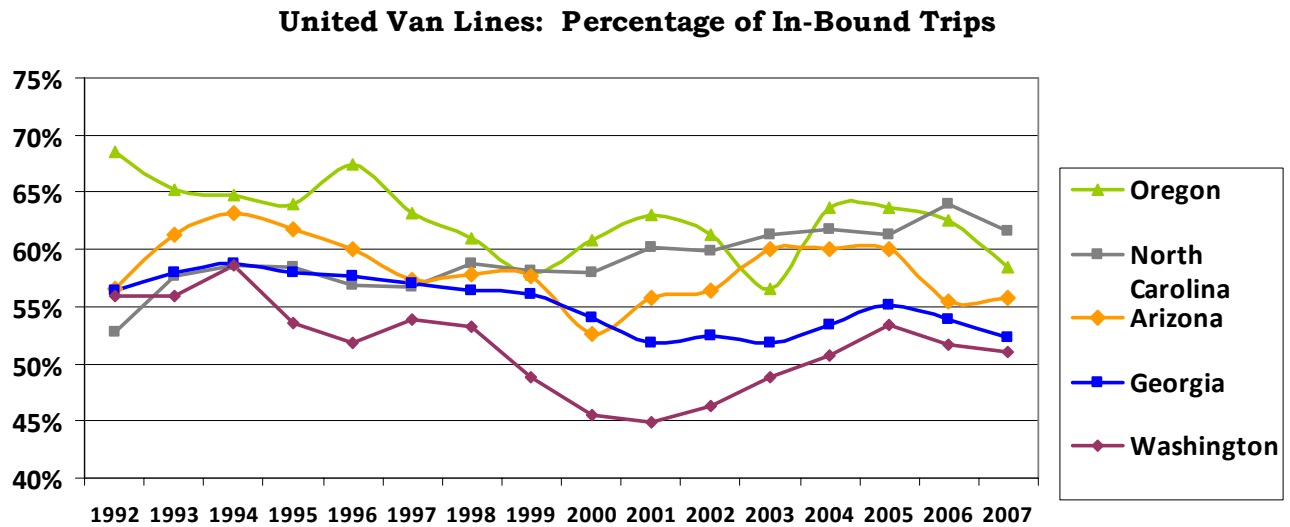
Portland rated eighth in the country at attracting this age group between 1990 and 2000 at a 20% differential from the national average. Notable results from this study also showed that 54% of the urban creative class age group lived within three miles of the city center. Focus group interviews of 25 to 34 year olds new to Portland found that the group was attracted to the city by its size, walkability, public transportation, bike friendliness, distinctive neighborhoods, and independent businesses.

The new luxury apartments in the Pearl, downtown and the South Waterfront certainly embody many of these characteristics. The question remains, do young adults have the ability or the desire to pay \$2.30 a square foot for rent? Gary Winkler, a multifamily broker for Colliers International has his doubts. Mr. Winkler feels that Portland is more of a lifestyle city as opposed to a city driven by Fortune 500 companies. Many come to Portland with very little money and are attracted by the region's entrepreneurial spirit.

The high-end rental market does not need to capture all 25 to 34-year olds moving to town, but when the luxury capacity is increased from 11.7% to 24%, this group will factor into the success of the high-end market. One barometer to measure those that come to Oregon with higher incomes is to look at statistics from moving companies.

Based on information provided by United Van Lines we see that Oregon has one of the highest percentages of net in-bound moves among the fifty states. United Van Lines publishes information on the percentage of in-bound versus out-bound trips from over 200,000 interstate moves the company makes annually. Unfortunately, United Van Lines does not provide specifics as to number of trips, or metropolitan origination and end-move areas. In the case of Oregon, since the metropolitan area accounts for approximately 60% of the state's population it is assumed that a majority of in-bound United Van Line trips are to the Portland area.

¹⁰ The Young and the Restless, How Portland Competes for Talent, Impresa Inc. and Coletta and Company, 2004



*Source: *United Van Lines*

The graph above shows that Oregon has easily maintained more than 55% in-bound trips since 1992. There were only three years in this time span when Oregon did not record higher than a 60% in-bound ratio, with one of those years being 2007 (58.4% in-bound). Based on this data, Oregon has consistently ranked as one of the most popular states for relocations. In a forecast released by Metro in July of 2007, the City of Portland is projected to add another 125,000 people in the next 23 years.¹¹ This would require the city to add another 55,000 housing units. Considering the lack of available open space, and the price of land it is apparent that larger multifamily developments will likely become more common in the future.

¹¹ Redden, Jim, "Move to Portland, and Live Where?", *The Portland Tribune*, July 31, 2007.

III. Income Requirements for Luxury Rentals

Aside from professional transplants who else lives in luxury rentals? Interviews with developers and apartment managers show that there is a broad variety of groups that are attracted to this rental class. The most common groups are:

1. Young creative professionals with good incomes;
2. Young married couples without children;
3. Middle-aged single men and women;
4. Older empty nesters looking to downsize; and
5. Wealthy out-of-state individuals looking to maintain a Portland residence.

The common denominator for all of these groups is that they have incomes well above the current median family incomes for the region. For those interested in renting a luxury unit, the basic requirement for most management companies is that the gross incomes for the renters be three times the required rent. Median Family Income (MFI) for the Portland region in 2008 according to the Portland Development Commission is \$47,250 for an individual and \$60,750 for a family of three.

The rule of thumb is to assume that people are willing to spend between 30 percent and 40 percent of their income on housing. With this simple assumption, we see that someone earning \$47,250 per year should be able to afford a 595-square foot one-bedroom at the Cyan for \$1,338 and that a young couple with a combined income of \$4,500 per month could live in a 750-square foot one bedroom at the Asa for \$1,800 per month.

| # of Bedrooms | Household Size | 100% Median Family Income | Monthly Housing Cost @ 30% of income | Monthly Housing Cost @ 40% of income |
|---------------|----------------|---------------------------|--------------------------------------|--------------------------------------|
| 0 | 1 | \$47,250 | \$1,181 | \$1,575 |
| 1 | 2 | \$54,000 | \$1,350 | \$1,800 |
| 2 | 3 | \$60,750 | \$1,519 | \$2,025 |
| 3 | 4 | \$67,500 | \$1,688 | \$2,250 |
| 4 | 5 | \$72,900 | \$1,823 | \$2,430 |
| 5 | 6 | \$78,300 | \$1,958 | \$2,610 |

*Source: Portland Development Commission,
http://www.pdc.us/housing_services/resources/median_family_income/default.asp

The problem with this simple calculation is that the MFI figures are not adjusted for taxes. In reality, someone spending over \$14,000 per year for rent on a gross income of \$47,000 will not have much money left over for other necessities, let alone the indulgences that come with the urbane downtown lifestyle. A more realistic approach is to deduct taxes. Since we pay both state and federal income taxes here in Oregon, it is assumed that most will have to pay a total of about 35% of their gross income in taxes. Once the tax burden is taken out, we see that the necessary incomes required to rent a luxury unit are substantially higher than those shown in the preceding table.

| Single Income | Income | Income Less 35% tax | Monthly Housing Cost @ 30% of income | Monthly Housing Cost @ 40% of income |
|----------------------|---------------|----------------------------|---|---|
| 100% MFI | \$47,250 | \$30,713 | \$768 | \$1,024 |
| 150% MFI | \$70,875 | \$46,069 | \$1,152 | \$1,536 |
| 175% MFI | \$82,688 | \$53,747 | \$1,344 | \$1,792 |
| 200% MFI | \$94,500 | \$61,425 | \$1,536 | \$2,048 |
| 250% MFI | \$118,125 | \$76,781 | \$1,920 | \$2,559 |
| 300% MFI | \$141,750 | \$92,138 | \$2,303 | \$3,071 |
| 400% MFI | \$189,000 | \$122,850 | \$3,071 | \$4,095 |

Taking out taxes changes the income requirements dramatically. Now, our fellow grossing \$47,000 per year will have to spend over 40 percent of his after tax income to afford a one-bedroom at the Cyan. In order to rent a 750-square-foot, one-bedroom with an average rent of \$2.30 per square foot and not exceed more than 30% of after tax income the renter(s) would need to have a yearly income above \$100,000. And for those interested in renting the two story \$7,500 per month penthouse at the Ardea without spending more than 30% of after-tax income on housing, one will need to earn \$460,000 per year.

IV. Bigger Challenges for Some Rentals Originally Designed as Condominiums

Portland's luxury rental market will be increasingly competitive since six buildings originally planned as condominium developments have converted to luxury apartments due to sluggish sales. In the last year and a half, 1,551 luxury units have been added to the market through condominium building reversions.

| Building | Apt. Units | Condo Units | Avg. Apt. Unit Size | Completion | Developer/Owner |
|-----------------------|-------------------|--------------------|----------------------------|-------------------|------------------------|
| Ladd Tower | 332 | 220 | 750 | 2008 | Opus Northwest |
| The Wyatt | 245 | 245 | 1117 | 2007 | Sobrato |
| Harrison South | 188 | 188 | 775 | 2007 | Bean/W&D/Reliance |
| 2121 Belmont | 109 | 109 | 1017 | 2008 | Williams & Dame |
| 3720 (Ardea) | 323 | 323 | 1100 | 2008 | Gerding Edlen |
| Cyan | 354 | 354 | 650 | 2008 | Gerding Edlen |
| | 1551 | 1439 | | | |

The most significant difference between buildings designed as condominiums and apartment buildings is the size of the units. Condominium units are generally larger, averaging over 1,000 square feet, whereas apartment units average 750 square feet. Opus Northwest's Ladd Tower was the first building to convert to apartments in the spring of 2007. Since construction had not yet started when the decision to convert to apartments was made, Opus redesigned the building to accommodate the smaller size apartment format. Although Opus kept the building's floor area ratio the same, by downsizing the units they were able to add another 112 units.

The other buildings that converted did not have the luxury of redesigning since construction was well underway, and in some cases substantially complete, when the decision to change to apartments was made. The problem with converting late, other than not being able to downsize the units, is that high-end finishes were installed and the construction loan amounts set. The Portland Business Journal reported that Gerding-Edlen brought in Kennedy Associates Real Estate for a \$145-million equity investment in the 323-unit Ardea (formerly the 3720) on the South Waterfront.¹² This works out to over \$448,000 per unit and does not include costs associated with the first-floor retail or 380 spaces of underground parking.¹³

Across the street from the Ardea sits Trammell Crow Residential's 294-unit Alexan. Built as apartments, the average unit size for the Alexan runs about 750 square feet. The loan to build the Alexan, minus the cost of the first floor retail and the structured parking, is reportedly \$90 million or about \$306,000 per unit.¹⁴ Although this is not inexpensive, it is less than 70% of the cost to construct the Ardea.

Because the Ardea has a higher cost per unit, along with a larger unit size, compared to the Alexan, and therefore a higher loan amount, it will also be more difficult for the Ardea to lower rents to maintain a profit. Although both buildings will have identical asking rents averaging between \$2.30 and \$2.40 per square foot, the overall rents per unit will be noticeably higher for the Ardea due to the larger unit size. For a one-bedroom unit, the Ardea's asking rents will average \$2,585, as compared to \$1,763 for the Alexan, which is a difference of \$822.

Consumer preferences for less expensive smaller units are already apparent. Riverstone HSC, which manages the Louisa, the Asa, Harrison Tower, and the Vue, reports that the Asa in the Pearl District, with an average unit size of 780 square feet, has not had to offer any incentives to attract renters. Across the street, however, the Wyatt, with units averaging over 1,100 square feet, has offered incentives of up to two months of free rent to entice renters.

V. The Shadow Market

The current glut of unsold condominiums, and those purchased speculatively, also poses a challenge for the new luxury buildings. As discussed in the condominium article in this issue of the journal, the shadow market in Portland is now estimated to number anywhere between 500 and 700 units. A cursory search on Craigslist reveals no shortage of listings for units in the Pearl, South Waterfront and downtown. Many units are in buildings that have been constructed in the last few years. More importantly, many current listings are priced well below \$2.30 per square foot.

| |
|--|
| Sep 3 - \$1395 / 1br - John Ross - 3601 SW River Parkway # 804 - (3601 SW River Parkway # 804)  |
| Sep 3 - \$1495 / 1br - The John Ross "24th Floor" Best Value - (South Waterfront,Downtown, Pearl)  |
| Sep 3 - \$1150 / 1br - Beautiful studio in the John Ross condo - (3601 SW RIVER PARKWAY 1007, PORTLAND OR)  |
| Sep 3 - \$1150 / 1br - Urban living at it's finest with exceptional views - (3601 SW RIVER PARKWAY ST #811, PORTLAND)  |
| Sep 3 - \$1050 / 1br - 14th floor studio located in the John Ross Building - (3601 SW RIVER PARKWAY ST #1407, PORTLAND)  |
| Sep 3 - \$1275 / 1br - PARK HOMES! TRUE ONE BEDROOM condo walking distance to OHSU Tram - (3601 SW RIVER PARKWAY #405, PORTLAND)  |

Source: Craigslist ads for apartments in the John Ross from September 3, 2008.

¹² Culverwell, Wendy, "Gerding Edlen's 3720 to Open as Apartments", Portland Business Journal, May 23, 2008.

¹³ Culverwell, Wendy, "Apartment Ambitions", Portland Business Journal, August 8, 2008.

¹⁴ Ibid.

Those desiring to live in the Pearl District or the South Waterfront can rent for much less money than purchasing a comparable condominium. Condominium renters also very rarely need to pay fees related to parking or the condominium association fees which can easily range from \$300 to \$800 per month.

The downside may be that the condominium renter may not have in-unit management to provide consistent service. As Noel Johnson from Trammell Crow Residential points out, your rights in renting from an investor may be diminished. Renters may have non-responsive landlords who live in another state. At the price of luxury rentals, the typical renter will have higher service expectations.

Although many shadow listings appear to be posted by independent property management companies, they likely have little power to mediate disputes with neighboring owners within the building. Still, for those with moderate service expectations wanting to live in a high-end building, a condominium rental will be a suitable substitute for a luxury apartment. And there will likely be lower turnover in the condominium building as well as higher-income neighbors.

| Sample of Shadow Market from Craigslist, October 26, 2008 | | | | |
|---|------------|----------------|-------------|-------------------|
| Building | Unit Type | Square Footage | Asking Rent | Price/Square Foot |
| The Meriwether | 2 bd/2ba | 1,326 | \$1,800 | \$1.36 |
| The Edge Lofts | 1 bd/1ba | 1,050 | \$1,650 | \$1.57 |
| Pinnacle | 1 bd/1ba | 780 | \$1,200 | \$1.54 |
| The Civic | 1 bd/1ba | 885 | \$1,650 | \$1.86 |
| John Ross | 1 bd/1ba | 781 | \$1,295 | \$1.66 |
| Streetcar Lofts | 1 bd/1ba | 720 | \$1,500 | \$2.08 |
| The Vaux | 3 bd/2.5ba | 3,000 | \$3,995 | \$1.33 |
| Tanner Place | 2 bd/2ba | 1,401 | \$1,995 | \$1.42 |
| The Henry | 1 bd/1ba | 1,000 | \$1,995 | \$2.00 |

The larger question looming for luxury rentals is what impact the shadow market will have. Assuming that there are a modest 500 shadow units available for rent added to the luxury units fully completed by the end of summer of 2009 (2,693 units) with the existing luxury units from buildings constructed before 2006 (1,948 units), the luxury rental market numbers 5,141 units. The shadow market would account for 11.7% of the luxury rental units. It may not seem to be a significant share of the supply, but in a tight rental market, on-going shadow supply could significantly depress rents and occupancies at the margin.

VI. Rent v. Own

The last consideration is renting versus owning. Based upon individual motivations there can be advantages to either rent a luxury apartment or purchase a condominium. The advantage to owning a condominium is the ability to deduct the mortgage interest and property tax payments from income taxes. On the other hand, renting allows one to live in a high-quality building in the downtown core at substantially less than the price of a mortgage, condominium fees and property taxes. The table below illustrates the difference between renting and owning a one-bedroom, one-bathroom condominium or apartment measuring 1,100 square feet.

| 1-bedroom, 1-bathroom, 1,100 square feet | | | |
|--|-----------------|----------------------|-----------------|
| Condominium | | Luxury Rental | |
| Average Sale Price | \$465,000 | Price/Sq. Ft. | \$2.25 |
| Monthly Mortgage (30 yr fixed jumbo @ 7.22 % w/10% down) | \$2,802 | Rent | \$2,475 |
| Parking (in purchase price) | - | Parking | \$125 |
| HOA fees @ \$.30/sq ft. | \$330 | HOA | - |
| Property Tax @ \$4,200 annual | \$350 | Property Tax | - |
| Monthly Property Insurance | \$100 | Rental Insurance | \$21 |
| Monthly Total | \$3,582 | Monthly Total | \$2,621 |
| Annual Housing Payments | \$42,984 | Annual Total | \$31,452 |
| Condominium | | Luxury Rental | |
| Gross Income | \$125,000 | | \$125,000 |
| Annual Mortgage Interest | | | |
| Property Tax Deductions | \$7,002 | | \$0 |
| Tax Rate | 28% | | 28% |
| Tax Liability | \$33,039 | | \$35,000 |
| Annual Tax Liability + Housing Expenses | \$76,023 | Total | \$66,452 |
| + Opportunity Cost of 10%, down payment. \$46,500 @ 6.5% = \$3,023 | | | None |

The last item is the potential opportunity cost for providing a down payment for a condominium. Taken together, there is about a \$1,000 per month cost premium to buy a condominium versus renting a similar unit. Nor does this include the cost of repairs, refurbishment on sale or any sales commissions and other selling costs. In a stagnant to declining market, one cannot expect appreciation of unit value either. Given the difficulties in the housing market many of those interested in purchasing may choose to rent an apartment while prices correct.

VII. Conclusion

Between early 2008 and late 2010 Portland will add over 3,000 luxury rental apartments to the urban core. Almost half of these units were originally planned as condominiums during a red-hot housing market. With the wilting housing market, developers switched buildings to a rental format in order to take advantage of Portland's emerging apartment market and to cut expected losses and risks in a decimated condominium market.

In the last two years Portland's existing high-end rental buildings have enjoyed occupancy levels exceeding 95 percent, which indicated a viable market for renters willing to pay over \$2.00 a square foot. Whether or not this market will absorb another 3,000 luxury units remains to be seen. The past five months have seen challenges unfold from inflation in fuel and commodities, to rising unemployment and the possibility of a worldwide recession. Although Portland is well positioned, relatively speaking, for this recession, most economists are predicting a prolonged downturn lasting into 2010.

Recent leasing activity within the current luxury rental market indicates that there are already significant concessions being offered. With another 1,828 units coming online in the next eleven months, a persistent shadow supply of at least 500 – 700 unsold condominiums and those purchased on speculation now available for rent in a time of rising unemployment, decreased consumption and stagnating wages, it appears that the luxury rental market in Portland may well experience declining rents and rising vacancies. However, the economics of renting versus owning suggest that cost premiums of at least \$1,000 per month are needed to buy versus rent a condominium or high-end rental unit. This may offer some support to the high-end rental market.

Housing Market Analysis

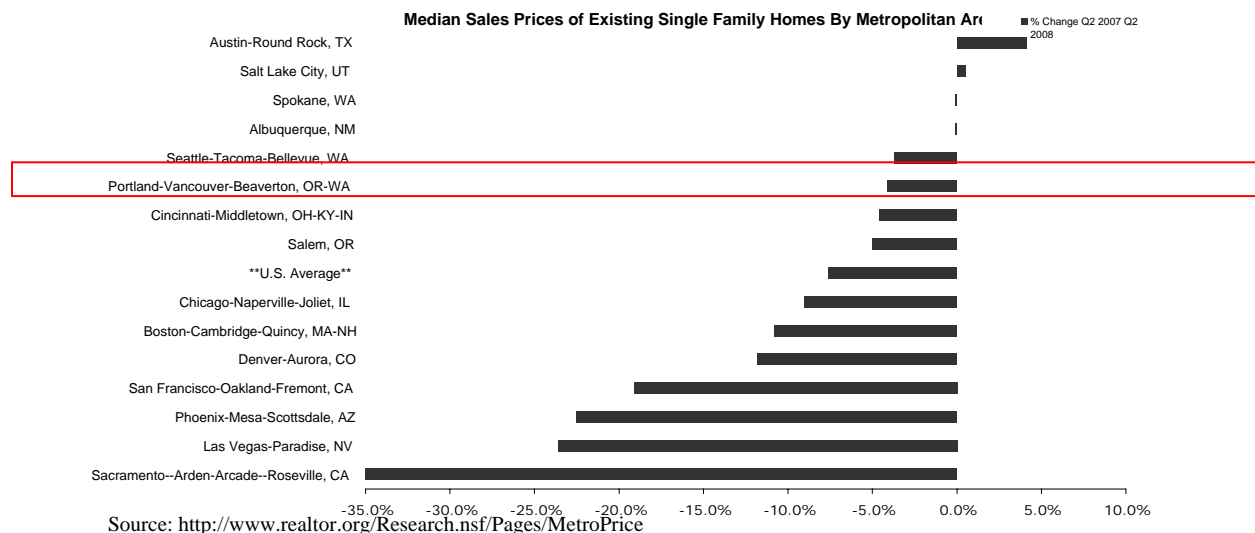
By Elizabeth Warren, Certificate of Real Estate Development Graduate Student &
Oregon Association of Realtors [OAR] Fellow

Median Home Values of Existing Detached Homes

| | U.S. | West | Portland Metro Area |
|--------------------------------|------------|------------|---------------------|
| August 2007 Median Sales Price | \$ 223,700 | \$ 339,100 | \$ 316,000 |
| August 2008 Median Sales Price | \$ 201,900 | \$ 254,900 | \$ 289,900 |
| % Change in Median Sales Price | -9.7% | -24.8% | -8.26% |
| % Change in Number of Sales | | | |
| August 2007-2008 | -9.6% | 6.5% | -32.35% |

Source: National Association of Realtors (August 2008) and RMLS (August 2008)

Third quarter results exhibited the expected slowdown in housing market activity. Nationwide, median home values are down 3.2% from second quarter. The west coast market has been hit hard this past year, reporting a distressing 24.8% depreciation in existing housing stock. Single-family building permits are down 50% annually, and the heavier than normal inventories have brought days on the market up from last quarter. While home prices have not dropped as dramatically in the Portland area, August saw the number of transactions drop from 1,901 in 2007 to 1,286 transactions in 2008. This year will mark the slowest year since the early 1980s for single family construction in the Portland Metro.¹



The Portland-Vancouver market has stayed relatively resilient during the housing market crunch.² A national snapshot puts into perspective how hard housing markets are impacted across the board, with the southern west coast struggling dramatically more than it's northern neighbors. Portland ranked 5th in the nation for lowest price decline in the recent economic crisis; it was the seventh most overvalued market in the US.

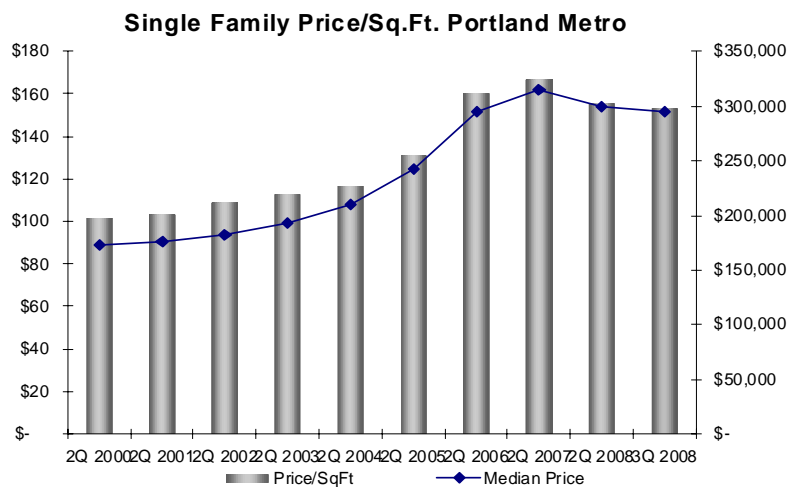
¹ Portland statistics provided by Mark D. Barry & Associates – The Portland Area Apartment Market – A Review of YTD 2008 and a Look Forward to 2009

Building Permits Issued*Year to Date*

| | SINGLE-FAMILY | | | MULTIFAMILY | | |
|------------------------------------|---------------|--------------|-------------|--------------|--------------|-------------|
| | Aug-08 | Aug-07 | PCT CHG | Aug-08 | Aug-07 | PCT CHG |
| UNITED STATES | 435.3 | 739.0 | -41% | 245.2 | 275.2 | -11% |
| OREGON | 6.19 | 12.64 | -51% | 3.41 | 4.15 | -18% |
| Portland-Vancouver-Beaverton OR-WA | 3.34 | 6.60 | -49% | 2.94 | 3.38 | -13% |
| * Bend OR | 0.52 | 1.28 | -59% | 0.08 | 0.14 | -41% |
| Eugene-Springfield OR | 0.48 | 0.79 | -39% | 0.12 | 0.33 | -64% |
| Salem OR | 0.42 | 0.81 | -48% | 0.21 | 0.23 | -11% |
| Medford OR | 0.31 | 0.85 | -64% | 0.05 | 0.08 | -37% |
| * Corvallis OR | 0.03 | 0.09 | -67% | - | 0.02 | - |

Portland

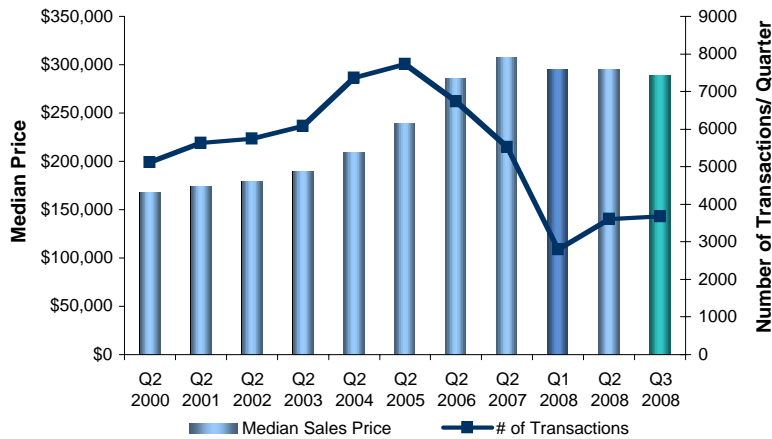
As the effects of the recent market downturn continue, it is important to step back from the housing bubble phenomenon and see the longer view trends that are emerging. Although annual median values are down across the state, Portland's price per square foot remains well above the pre-bubble values of 2000 and still higher than in 2005, after prices had already risen about 50%. Additionally, housing values are still relatively higher than the first housing bubble Portland experienced during the technology boom of 2004. This trend proves comparatively similar for the median housing price as well, with per-square-foot price decreasing slightly more in recent years. Annually, market activity did reveal the continued housing downturn, with median prices down 7% for existing single-family homes.³ Average days on market remained in the mid-60 range, and sellers began receiving a 93.64% ratio of return between their original and final sales prices. For new, detached homes, the median sales price dropped 2.73%, and number of transactions up 6% from the dismal results of second quarter. During this post-bubble period, Portland remains relatively resilient from the extreme inventory depreciation states such as Arizona, Nevada, and Florida are now experiencing.



³ All Single Family Home data was compiled from RMLS (September 2008)

Median Sales Price & Number of Homes Sales Per Quarter - Existing Detached Homes

Portland Metro (Excluding Clark County)



8-Year outlook for Median Sales Price & Number of transactions

3rd Quarter Median Price: \$289,900

Quarterly % Change: -1.73%

Annual % Change: -6.99%

Number of Transactions: 3,672

Quarterly % Change: 2.34%

Annual % Change: -22.17%

Sale Price/Original List Price & Average Days on Market – Existing Detached Homes

Portland Metro (Excluding Clark County)

2-Year outlook for Average DOM and Sales Price/Original List Price ratio

3rd Quarter Sale/Original ratio: 93.64

Quarterly % Change: 2.19%

Annual % Change: -2.44%

Days on Market: 65

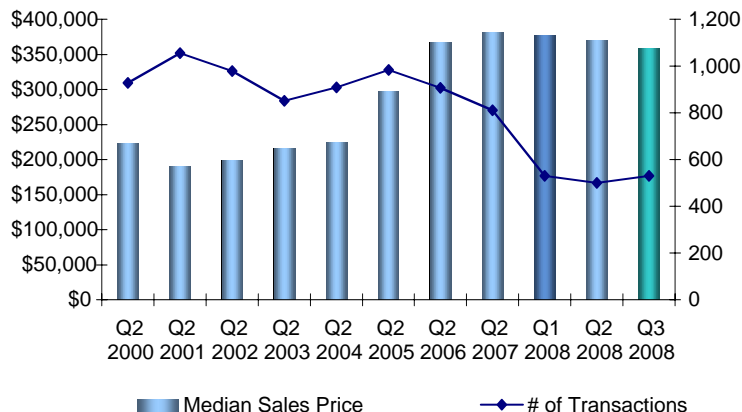
Quarterly % Change: 3.17%

Annual % Change: 32.65%



Median Sales Price & Number of Transactions – New Detached Homes

Portland Metro (Excluding Clark County)



8-Year outlook for new construction single-family home sales

3rd Quarter Median Price: \$359,900

Quarterly % Change: -2.73%

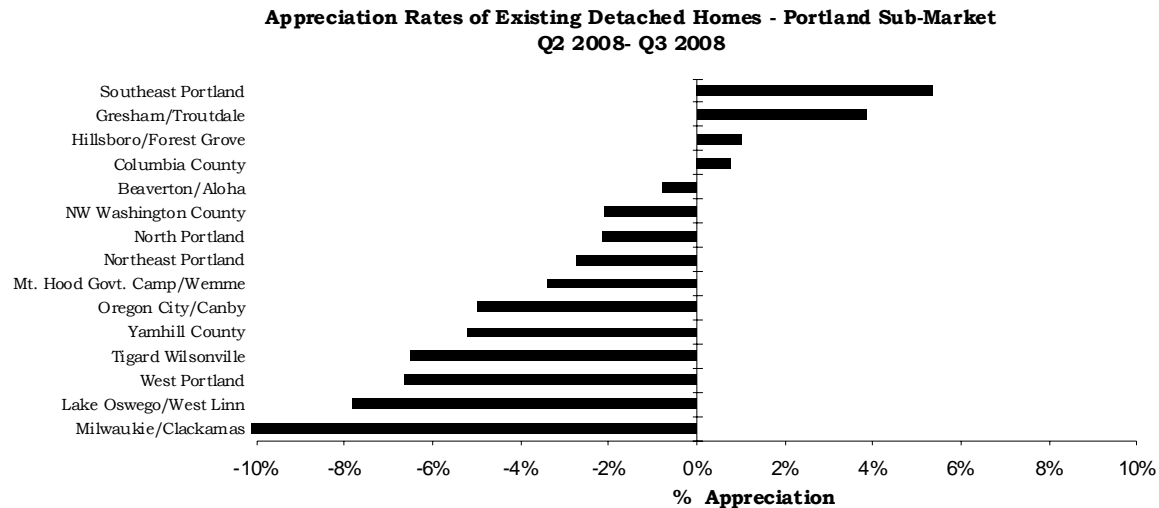
Annual % Change: -2.99%

Number of Transactions: 529

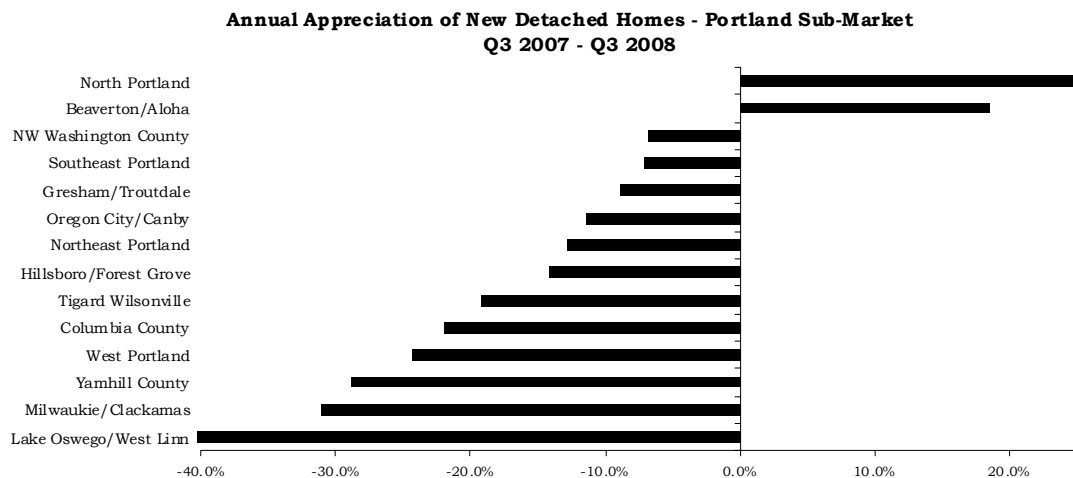
Quarterly % Change: 5.80%

Annual % Change: -23.88%

Annual depreciation for the Portland area's existing housing stock continues its slow decline from the recent market downturn. None of the 15 statistical areas achieved positive annual gains, and Columbia County experienced an 18.4% annual decline in median values. In the short-term, the number of market area's enjoying third quarter appreciation - 4 of the 15 statistical areas – is up from second quarter's count of one.

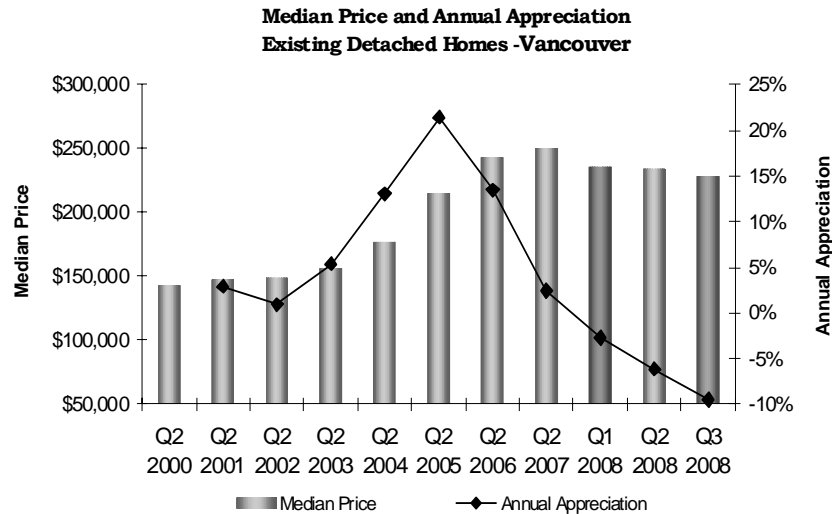


The North Portland neighborhood remains the strongest again this quarter for new-construction homes. Beaverton has joined this category with an 18.5% appreciation from the third quarter of 2007; values of new detached homes hit a \$375,950 median price (median price for third quarter 2007 was \$317,250).

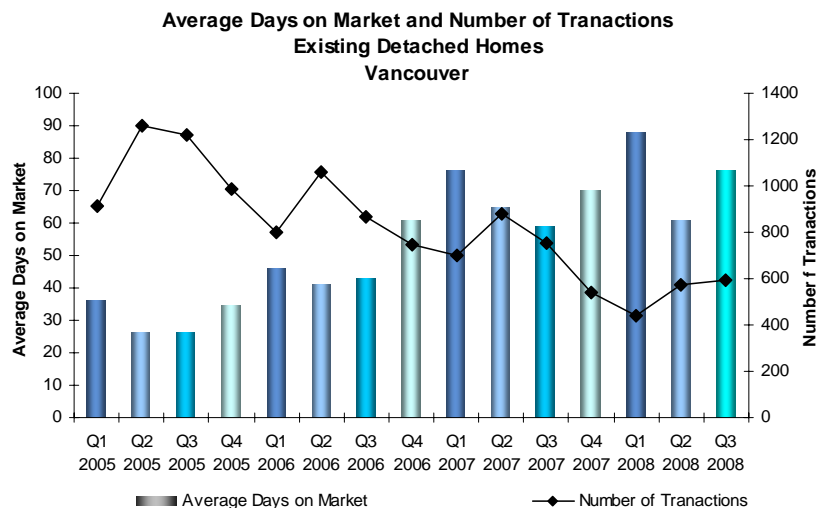


Vancouver

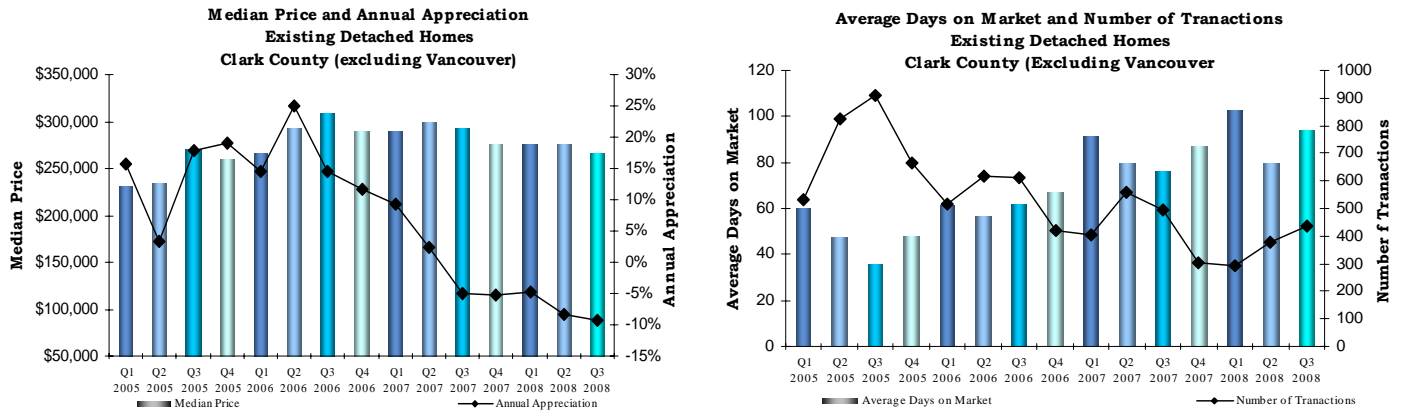
Third quarter median prices for central Vancouver's existing detached homes continued its relatively stable price decline, decreasing by only 2.5%— from \$234,700 to \$229,000 – since second quarter.⁴ Annual comparison to 2007 shows a more dramatic result of 9.5% decrease in median price.



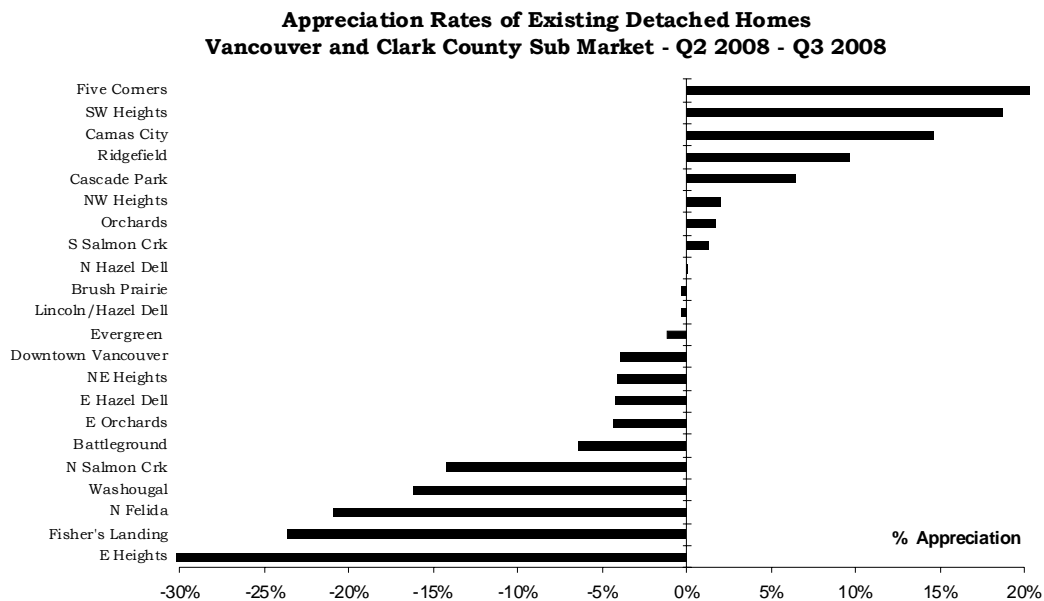
Although days on the market went up considerably - from Q2's 61 to 76 days - the number of transactions also increased slightly from last quarter, perhaps stabilizing the rising time spent on the market. In Clark County, a similar situation occurred, with slightly less dramatic shifts. In this area, days on the market increased by 18% while the number of transactions increased 16% since last quarter. As is shown in the chart below, Vancouver has shown a disturbing trend since 2005 of gradually increasing the number of days on the market as the number of transactions gradually decreased.



⁴ All data for Vancouver was compiled from RMLS (August 2008)

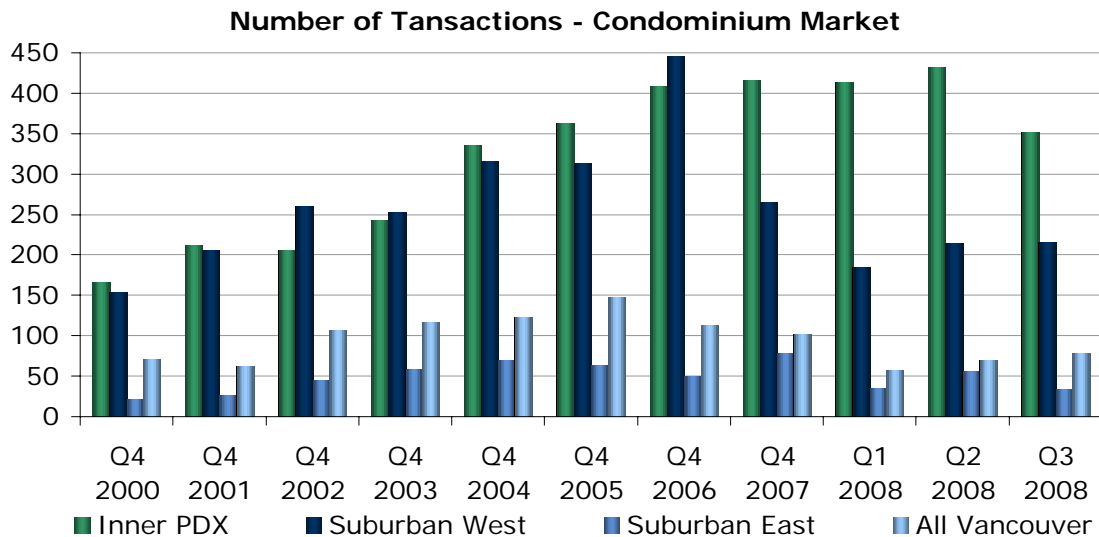
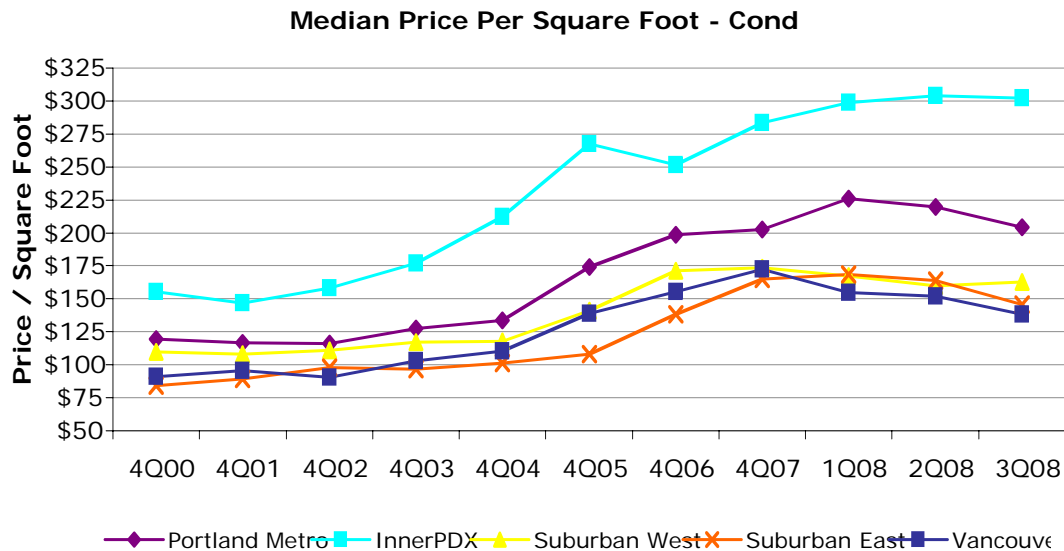


Existing home sales in the Vancouver and Clark County sub-market showed positive signs in terms of the number of areas appreciating. This quarter marked almost half with positive median sales gains. Annually, Downtown Vancouver enjoyed a 9.1% appreciation of its existing homes stock, as did Camas (9.7%), Brush Prairie (8.6%), and Lincoln/Hazel Dell (3.2%). Conversely, SW Heights marked a 28% annual depreciation. Cascade Park has seen prices rise through each quarter of 2008, while Five Corners saw a 36% price jump from the last quarter.

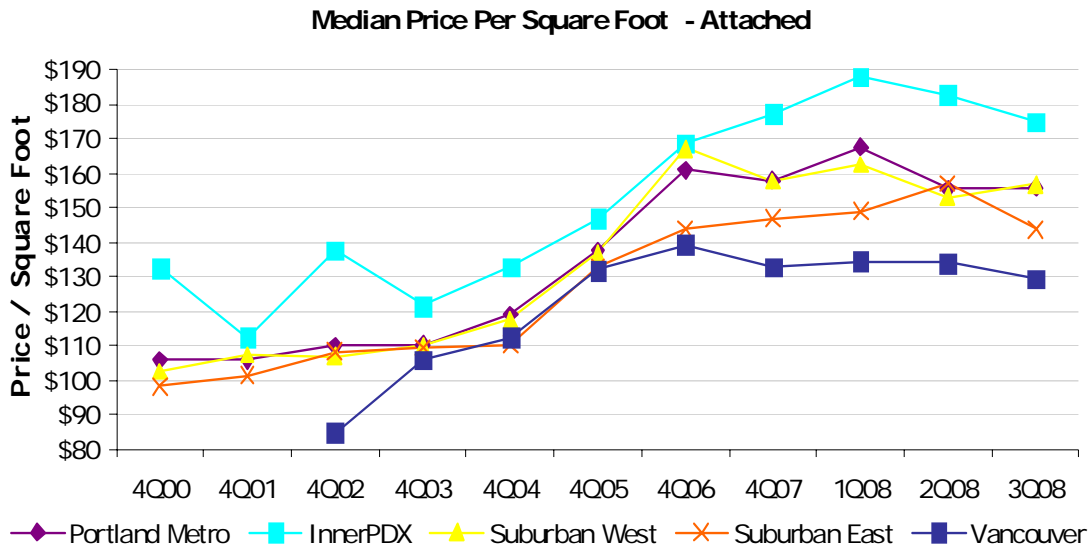


Condominium and Attached Market⁵

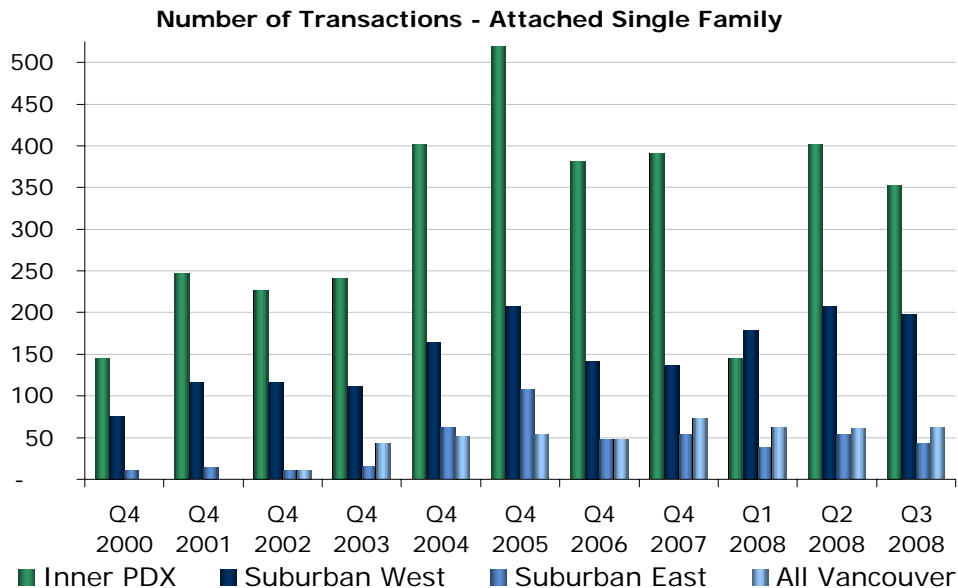
Though faring better than national averages and markets down the West coast, the condominium market reached new depths this quarter. The buyer markets seem to be continuing through the nation's financial crisis. The recent trend of condominium to apartment conversions has claimed two new developments this quarter: the 354-unit Cyan/PDX and the Pearl's 245-unit Wyatt both announced their conversion to apartments. Median price per square foot in the Portland metro area dropped 7% to \$204.00, and the number of transactions dropped 14% below the previous quarter. Again, the downtown Portland neighborhoods continue to show the strongest market for both attached and condominium development.



⁵ RMLS defines attached as "an element of the residence construction is shared with another property. Condominiums excluded. Condominiums are defined as an attached or stand-alone residence for which the owner has title to the space inside the unit and shares common spaces with other unit owners in accordance with specific legal guidelines.

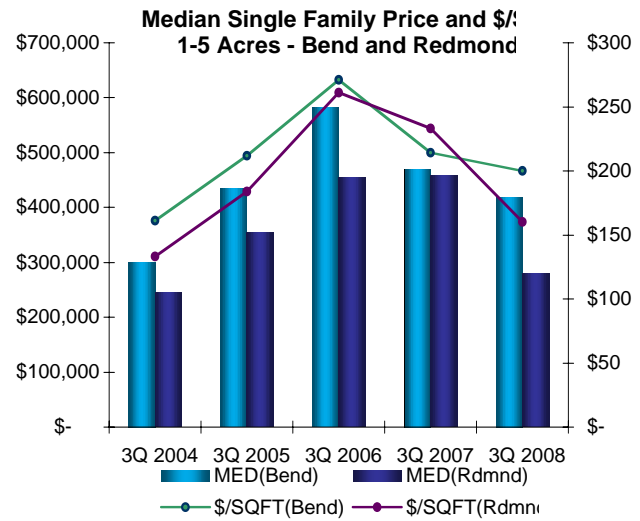
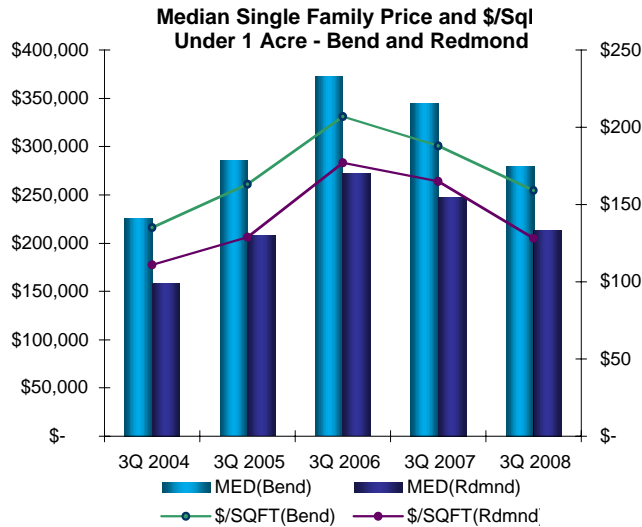


The attached single-family market appears to be almost at a standstill. The number of transactions went down dramatically across Portland. However, the price received for the sales stayed relatively stable. In Vancouver, although median sales were down 10%, the number of transactions increased by 16% in the central Vancouver area, while the city's suburbs enjoyed a strong 60% increase in number of sales from the previous quarter. As would be expected, annual appreciation was in the red across the board, as well as number of transactions in the metro area (Vancouver suburbs did however report an annual 33% increase single-family attached sales).

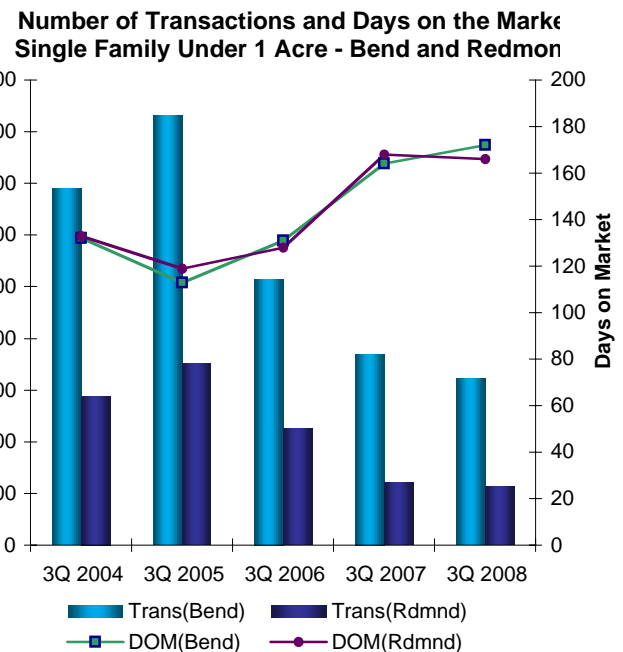
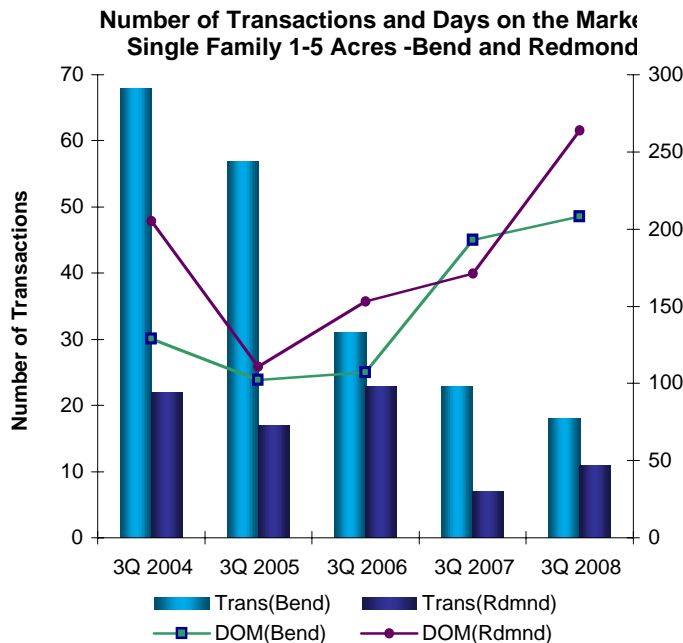


Central Oregon

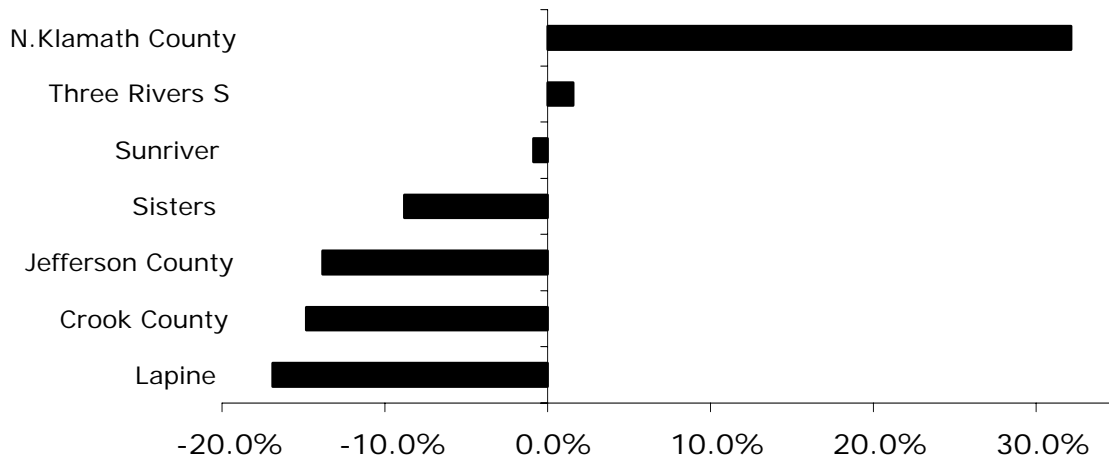
For the cities of Bend and Redmond, third quarter median sales price continued its slow decline along with the number of transactions, while average days on the market increased moderately. Since last quarter, median prices went down 8% to \$280,000 in Bend, followed by Redmond's decline of 5% to a median price of \$213,000. Annual appreciation was down 19% in Bend and 14% for Redmond.



As it is commonly reported in Central Oregon's reports, the housing stock is separated by lot size – properties under one acre and those between one and five acres. Price per square foot is provided to control for lot size between both categories. Here we see the continuing trend of declining prices after the peak in 2006. The number of days on the market and transactions, however, has been declining since 2004.



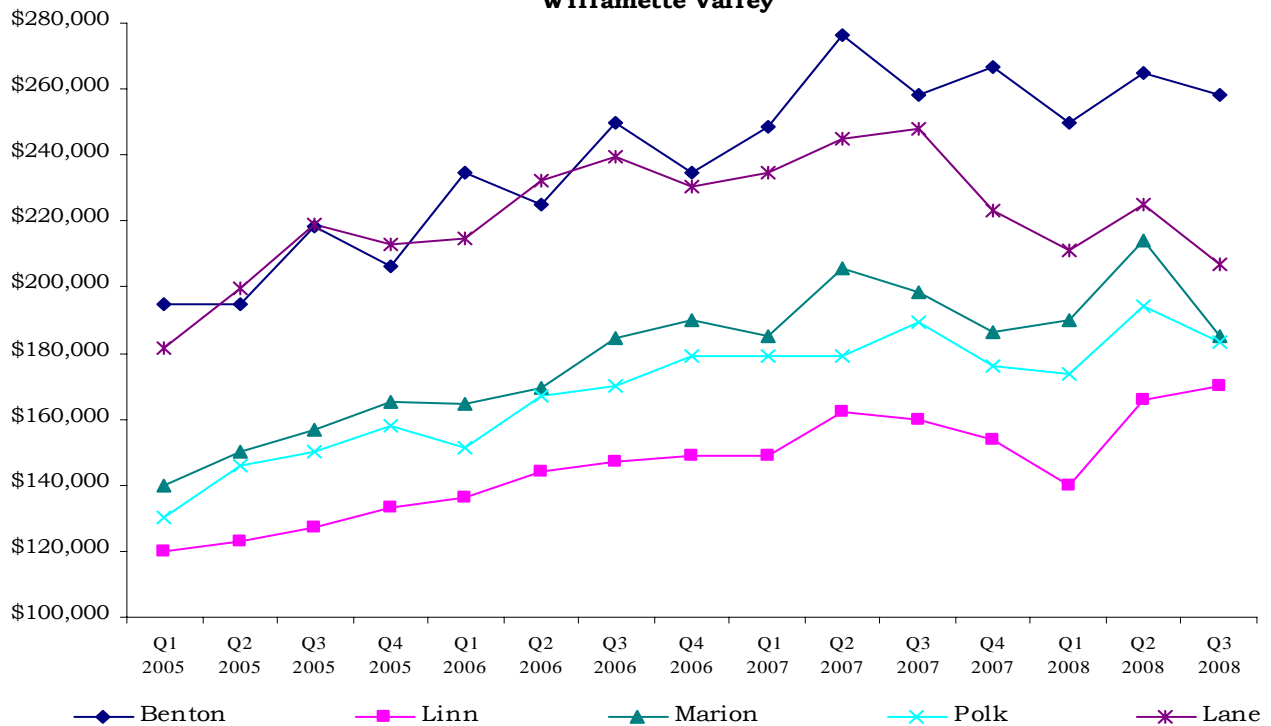
**Annual Appreciation for Central Oregon
3Q 2007 - 2008 - Single Family Detached Under**

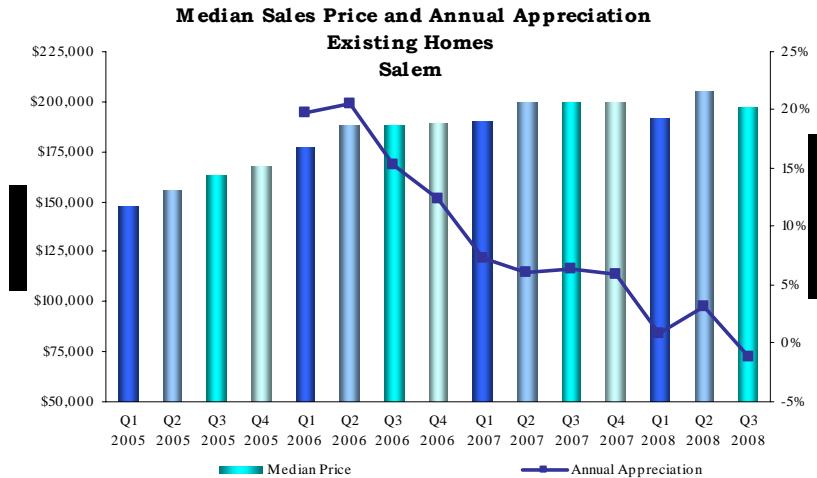


Willamette Valley

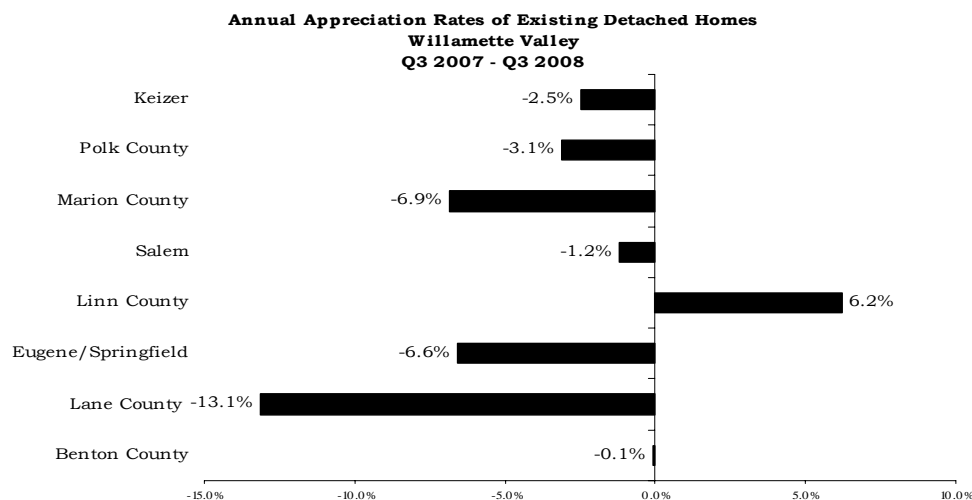
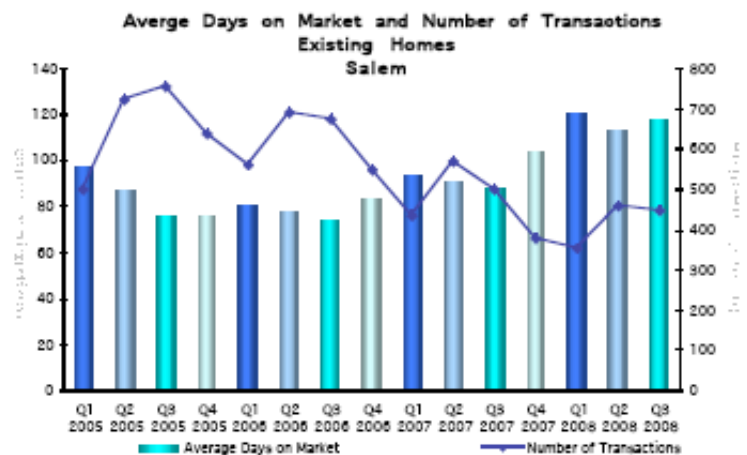
While experiencing a brief upturn in the second quarter housing prices, the counties of the Willamette Valley were no exception to the impact of the housing crisis felt nationwide. The third quarter brought lower median prices for all counties but Linn, where prices actually rose in both annual (6.2%) and quarterly prices (2.4%). However, when overlooking the second quarter price hike, the change in price through the past year has remained relatively steady, with prices making a slow comeback from 2008's first quarter slump.

**Median Sales Price
Existing Detached Homes
Willamette Valley**





In Salem, the existing housing stock follows the trend of its neighboring cities and counties. Median prices (\$197,500) are down 4% from second quarter, 1.2% annually, number of transactions is down, and average days on market remain at record highs. As mentioned before, annual depreciation of the Willamette Valley counties confirms that the impact of the national housing crisis continues in Oregon. However, in Linn County median prices up 6.2% to \$169,950 and the number of transactions is up 5.9%, Linn will be a good market to watch as we continue to see the effects on prices of the deleveraging of housing markets.



Retail Market Analysis¹

By Elizabeth Warren, Certificate of Real Estate Development Graduate Student &
Oregon Association of Realtors [OAR] Fellow

PORTLAND

QUICK STATISTICS

Going-In Cap Rate

Regional Mall

6.9 %

Terminal Cap Rate

Regional Mall

7.6 %

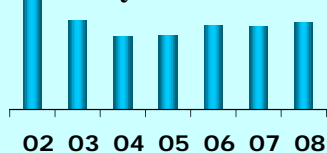
Inventory

Square Footage

40,117,551 *Integra*

45,940,307 *CBRE*

Vacancy **4.96%**



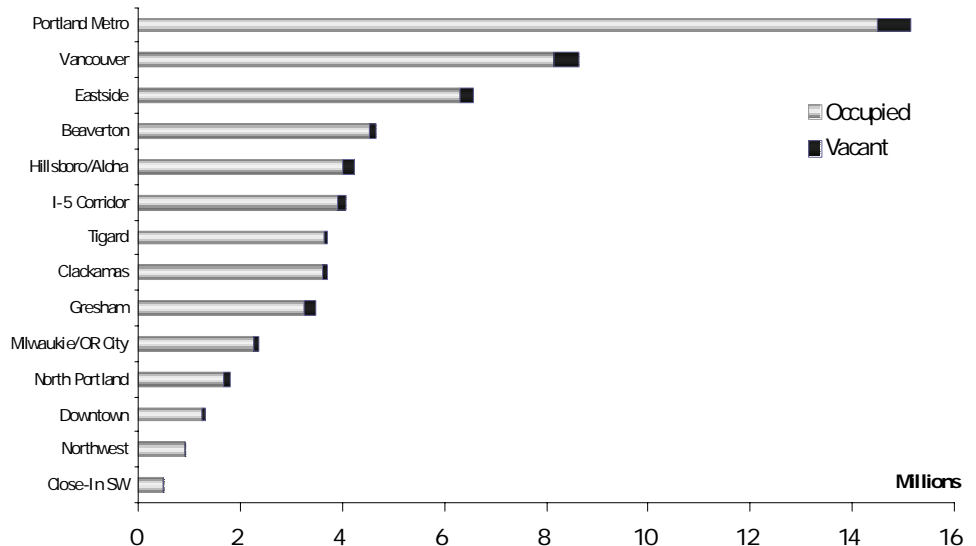
Annual Total Value Change

13%

Average Asking Rate

\$19.35/Sq.Ft.

Regional Retail : Gross Leaseable Area
3Q 2008



Portland's retail market remained strong in the third quarter of 2008. Gross Leaseable Area (GLA) is up a half percent overall, vacancy is down, and price-per-square-foot remains stable at \$19.35.

Vacancy

Portland's vacancy was reported down in the second quarter from 2007's fourth quarter, reporting a 4.5% vacancy. Retail vacancy declined one point since this time 2006, and 0.1% from 2007.

Net Absorption

According to Integra's recent publication, average annual net absorption was reported at 293,821 square feet. Final numbers for 2007 reported absorption of 327,118 SF into the market. CoStar's Retail Report lists:

Tenants vacating large block space in 2008 to include:

- Park City (9,800 SF vacating Wood Village Town Center)
- Eddie Bauer (8,310 SF vacating 700 SW Fifth Avenue)
- NW Dollar Store (7,265 SF vacating Meadowland Shopping Center)

Tenants moving into large block space to include:

- Fred Meyer (moving into 2500 Columbia House Blvd 139,000 SF)
- H Mart (moving into Tigard Marketplace 59,625 SF)
- 24-Hour Fitness (moving into Orchards Market Center 45,000 SF).

¹ Current and historical Portland Retail Data provided by CB Richard Ellis Real Estate Services

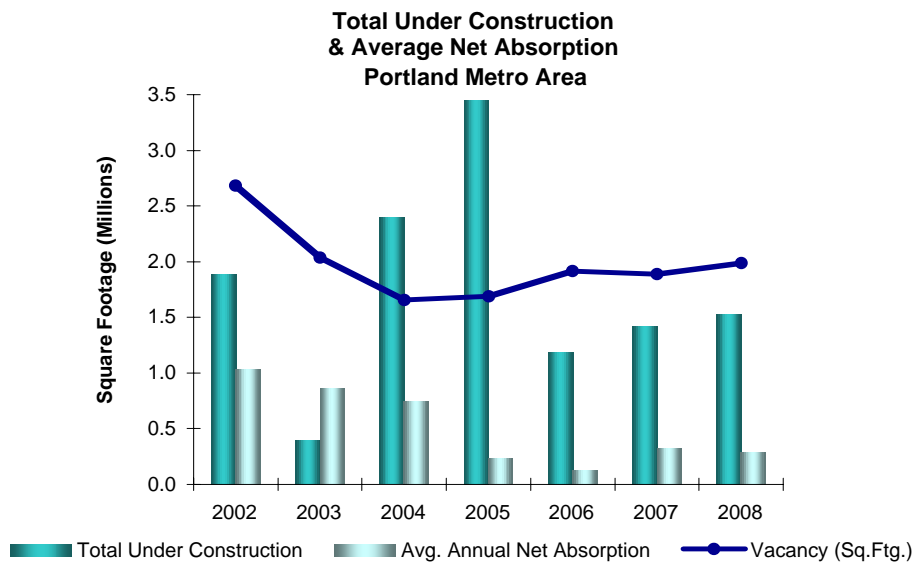
| 2Q08 | No. Bldgs | Gross Leasable Area | Occupied | Vacant | % Vacant | Avg. Asking Rate |
|----------------------|-----------|---------------------------|------------|---------|----------|---------------------|
| Vancouver | 98 | 8,629,579 | 8,142,264 | 487,315 | 5.6% | \$19.62 |
| Eastside | 73 | 6,568,852 | 6,304,298 | 264,554 | 4.0% | \$19.72 |
| Beaverton | 69 | 4,670,478 | 4,514,272 | 156,206 | 3.3% | \$19.93 |
| Hillsboro/Aloha | 47 | 4,238,531 | 3,992,307 | 246,224 | 5.8% | \$21.24 |
| I-5 Corridor | 63 | 4,079,141 | 3,903,404 | 175,737 | 4.3% | \$22.59 |
| Tigard | 33 | 3,715,825 | 3,630,034 | 85,791 | 2.3% | \$17.70 |
| Clackamas | 29 | 3,696,182 | 3,606,223 | 89,959 | 2.4% | \$27.00 |
| Gresham | 42 | 3,480,223 | 3,232,012 | 248,211 | 7.1% | \$14.34 |
| Milwaukie/OR City | 32 | 2,351,593 | 2,273,233 | 78,360 | 3.3% | \$18.80 |
| North Portland | 18 | 1,788,502 | 1,660,566 | 127,936 | 7.2% | \$11.30 |
| Downtown | 41 | 1,306,194 | 1,233,959 | 72,235 | 5.5% | \$25.97 |
| Northwest | 35 | 921,513 | 896,313 | 25,200 | 2.7% | \$24.66 |
| Close-In SW | 16 | 493,694 | 487,258 | 6,436 | 1.3% | \$19.28 |
| Portland Metro | 246 | 15,157,896 | 14,485,798 | 672,098 | 4.64% | \$20.59 |

Total Under Construction²

Integra Realty Resources reports that a total square footage of 1,531,906 square feet is under development in the Portland area. This is followed by a three-year forecast of 100,000 square feet of annual net absorption for 2008, with the same forecast for 2007 reported at 1.5 million square feet. The total value change experienced for the past three years is a positive 13%.

CoStar's notable deliveries included³:

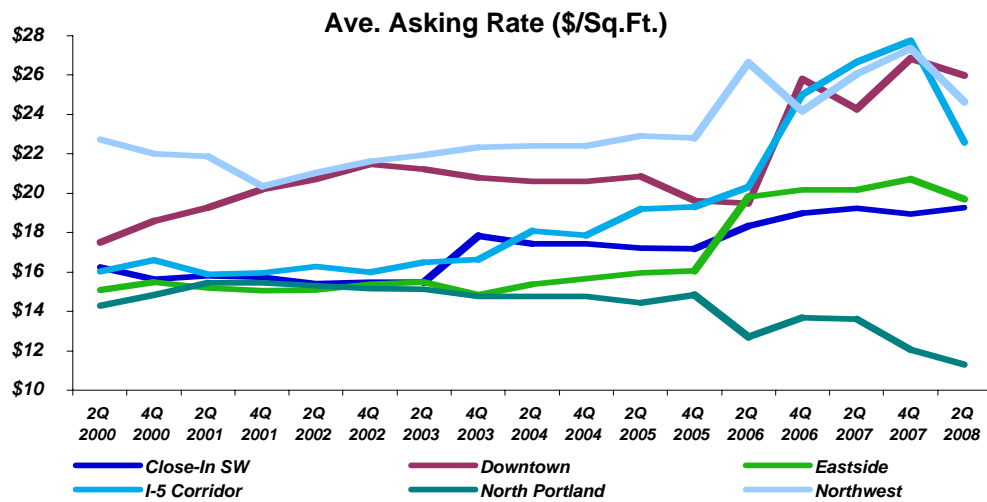
- 2500 Columbia House Blvd – 196,000-square-foot facility now 76% occupied
- 15639 SE Sunnyside Rd – 170,900-square-foot facility now 92% occupied
- JC Penney's – 105,000-square-foot building now 100% pre-leased
- 13001 NE Fourth Plain Blvd – 62,000-square-foot facility now 73% pre-leased.



* 3-Year Planned Total Under Construction ** 3-Year Historical Average Annual Net Absorption

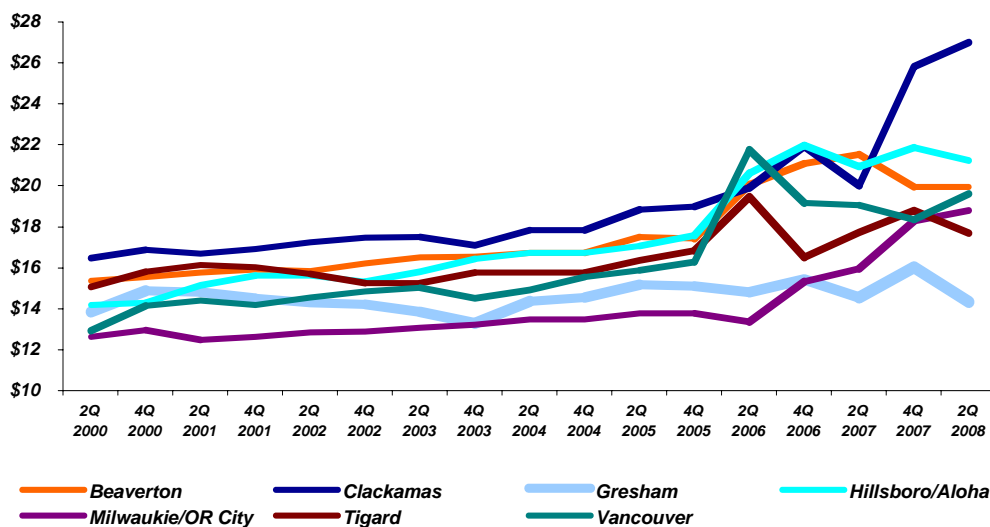
² Data provided by Integra Realty Service's Viewpoint publication

³ Data provided by CoStar Group's Mid-Year Retail Report



Rental Rates¹

Average quoted rental rates are down from 2007's unusually high rate of \$20.23 per square foot. However, the \$19.35 continues the slower trend upwards from 4Q 2006, \$19.23, and 2Q 2007, \$19.27. This calculates to a 0.42% annual increase in rental price.



¹ Rental Rates provided by CB Richard Ellis Realty Services

Office & Industrial Market Analysis

Greg LeBlanc, MBA, RMLS Fellow, & Certificate of Real Estate Development Student

Portland Office Market

The Portland office market continues to hold steady in the face of challenging economic times. Difficulties may be starting to surface in the suburbs, where vacancy in the last quarter has increased over a full percentage point to 14.7%. The downtown market continues to perform well where supply is tight. The current CBD vacancy experienced a modest drop to 8.1%, and Class A vacancy continues to hover around 5%. Despite the solid performance, brokers are reporting that tenants are hesitant to make any large leasing commitments until the economy shows signs of improving. While this is occurring, the downtown market will soon see the first 330,000 square feet of over 1.3 million square feet of new construction scheduled for completion by early 2011.

National Economy

What a difference 120 days makes. The discussion last quarter focused on the threat of inflation with rising food and fuel prices, the bail out of Fannie Mae and Freddie Mac, and the take over of Indy Mac bank by the Federal Deposit Insurance Corporation. Since that time, the national economy has taken a more dramatic turn for the worse, starting with the Chapter 11 bankruptcy filing by Lehman Brothers on September 14, 2008. The storied financial investment bank could no longer function under the weight of \$60 billion in real estate-backed holdings. Since Lehman's bankruptcy announcement the United States has seen:

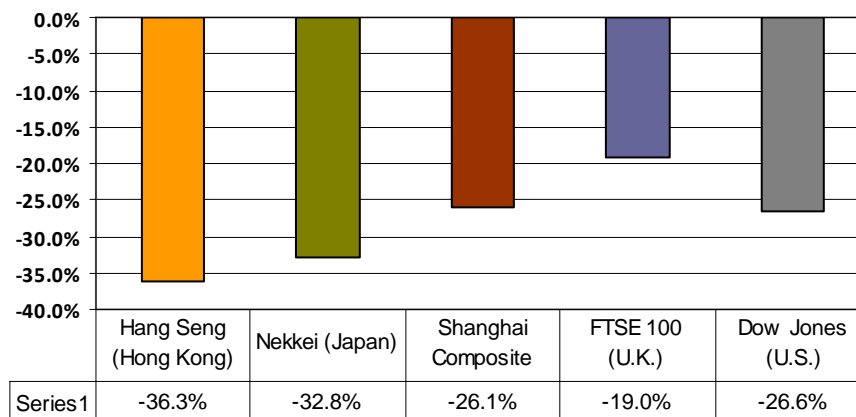
1. The largest bank failure in American history when Washington Mutual and its over \$300 billion in assets were sold off to JP Morgan Chase for \$1.9 billion. The bank's demise was brought on by an overexposure of risky home mortgages;
2. Bank of America's acquisition of Merrill Lynch for \$50 billion in an all stock deal;
3. An \$85 billion emergency loan by the U.S. government to insurance giant AIG;
4. A loan of \$180 billion to the nation's banks by the Federal Reserve and central banks around the world;
5. The purchase of troubled Wachovia Bank by Wells Fargo;
6. A \$700 billion emergency Federal bailout plan passed by the U.S. Congress to assist the national banking sector; and
7. A sell off of stocks in markets around the world with the U.S. Dow Industrial average dropping 14.1%¹ in October alone.

The good news is that inflation no longer appears to be a threat with commodity prices taking a dive. The price of crude oil has dropped over 53% from the July 28, 2008, high of \$147 per

¹ CBS MarketWatch, "Dow Suffers Worst October Since 1987"

barrel to \$67.81 a barrel on October, 31, 2008.² Taken in the context with what has gone on in other areas of the market, this volatility is not necessarily good news.

**Global Market Turmoil: % Decline
Between September 1, 2008 & October 27, 2008**



Source: Yahoo! Finance.com; accessed October 27, 2008

The latest release of the S&P/Case-Shiller home price index shows that home values are down 16.6% nationwide from a year earlier. A bright spot for the region is that the same index shows a more moderate drop of 7.6% for homes in the Portland area during this same time period.³ Unfortunately, many economists believe that home values will continue to slide in the next year, with Goldman Sachs predicting homes will depreciate an additional 15% nationwide before the bottom is reached.⁴ This massive contraction in home values feeds into additional foreclosures as more people find themselves owing more than their homes are worth. The end result is tighter lending standards as banks manage defaulted loans and attempt to correct their balance sheets.

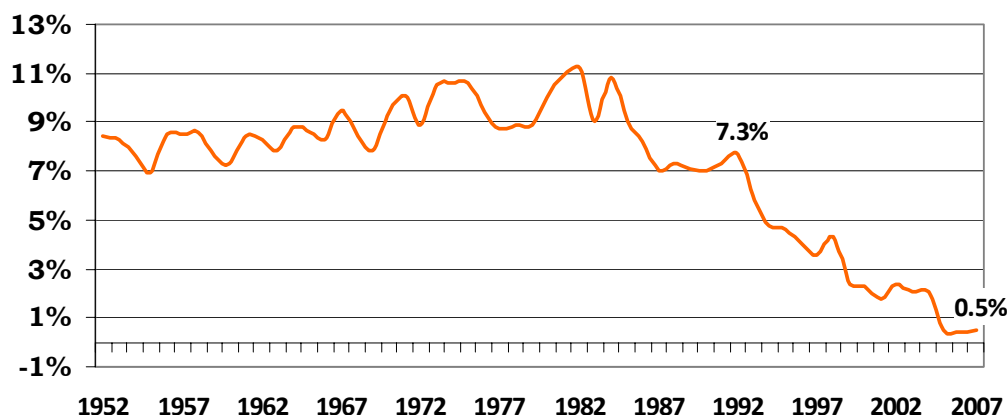
So how did we get into this predicament? The simple explanation is that the U.S. consumer has been on a massive buying spree since the late 1980's. Spurred by the availability of easy credit, Americans have spent lavishly on homes, cars, electronic gadgets and other discretionary goods. As of last year the rate of personal savings in the United States stood at 0.5%, down from over 7% in 1992. During this same time period there has not been a noticeable increase in the rate of real income.

² Ibid.

³ Standard & Poor's, S&P/Case-Shiller Home Price Indices, Historical Home Price Values

⁴ Lahart, Justin and Evans, Kelly, "Economists Search for End of Woes", Wall Street Journal, October 29, 2008.

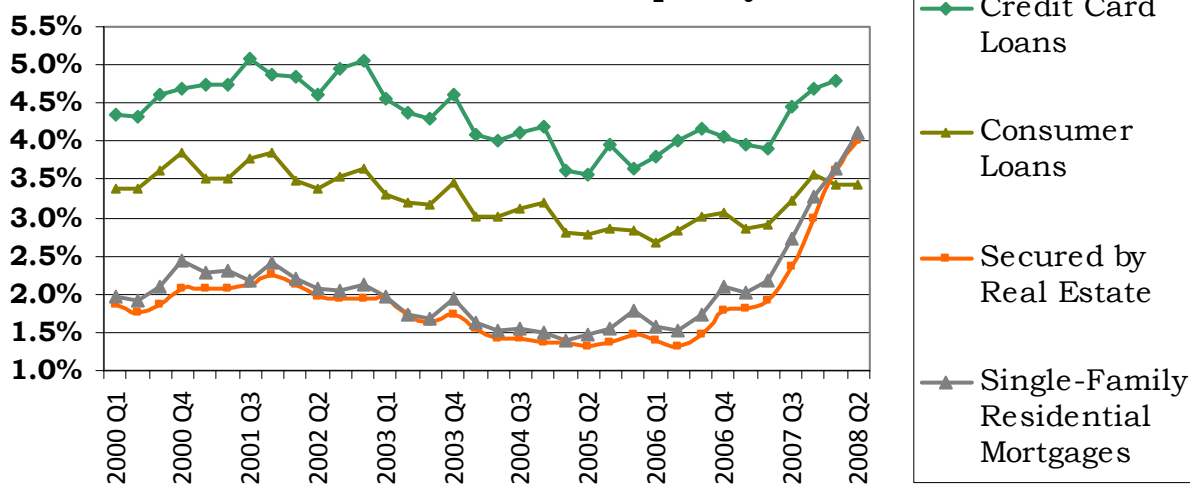
Rate of US Personal Savings (%)



Source: US Department of Commerce, Bureau of Economic Analysis

Due to the current condition of our national banking sector, it appears that the days of easy credit are over. This in turn has ignited deeper concerns because two-thirds of our economy is driven by consumer spending. The interesting phenomenon about this recession is that loan defaults preceded a rise in unemployment. With the rise in unemployment, however, defaults of all loan types are likely to continue. Add in tighter lending standards and reduced corporate profits and you have a self-reinforcing negative cycle.

National Loan Delinquency Rates



Source: Federal Reserve Board

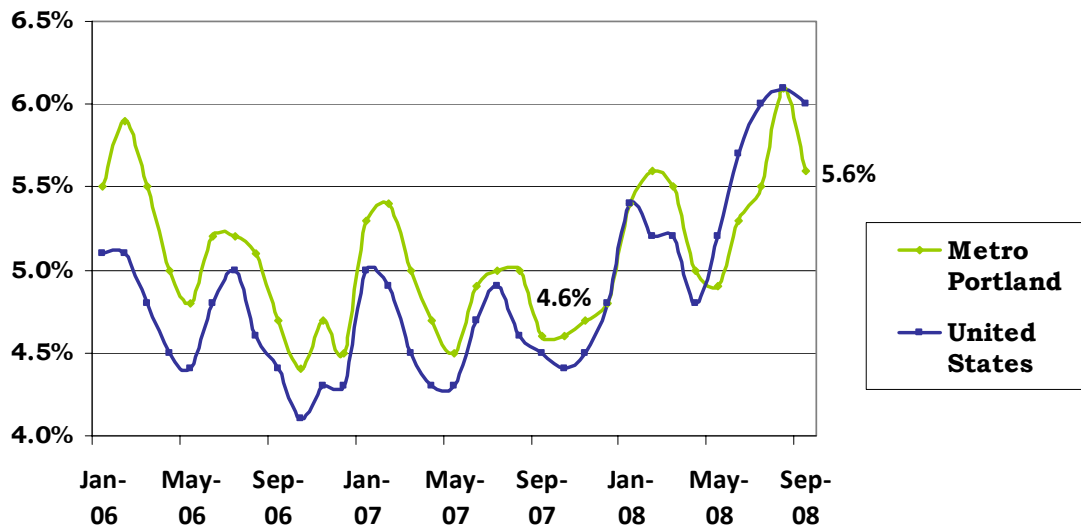
With problems on many different fronts within the economy economists are not predicting recovery to begin until the latter half of 2010. Businesses dependent on lines of credit or discretionary consumer spending will be put in difficult positions in the next year. This, of course, does not bode well for the commercial real estate market. The Urban Land Institute recently released a forecast for 2009. The prediction is that the commercial real estate market will hit bottom in 2009. The current landscape sees many owners overwhelmed by debt,

declining property cash flows, lenders unwilling to lend and a general avoidance of risk.⁵ Those that can manage debt and maintain an equity cushion will have the most success in navigating the market.

Oregon and Portland Economy⁶

The latest figures from the Oregon Employment Department show unemployment in the Portland metro area in September increased to 5.6%, an increase of 1% over September, 2007. In comparison, the national unemployment rate jumped over 1.6% to 6.1% in the same period. Portland's more moderate rate of employment is encouraging considering the last recession in 2001, when Portland led the country in unemployment.

Unemployment: Metro Portland v. United States



Source: Oregon Employment Department

Local employment sectors seeing the largest increase in job loss continue to be led by construction, followed by the trade and transportation, financial, and manufacturing sectors. In the last year, construction employment in the metro region has dropped by 5.4%, but has fared better than the 10.2% statewide drop in construction employment. Most of the regional decrease in construction employment has come from the residential market. Commercial activity is relatively strong in Portland with over one million square feet of office space alone under construction in the central business district. Financial based jobs continue to struggle both locally and state-wide. Although the sector did gain 300 jobs in Oregon for September, financing activities related to real estate continue to struggle. Cushman and Wakefield reports that the loss of jobs related to housing finance, like mortgage origination and title insurance, have been a significant component for the increase in the metro suburban vacancy rate from 13.7% to 15.3% rate.⁷

On the positive side, job gains continue to be led by healthcare, education, government and professional services. The education and healthcare sector saw the addition of 7,300 jobs in Oregon, or a gain of 1,700 more jobs than normally added for the month. Most of the gain

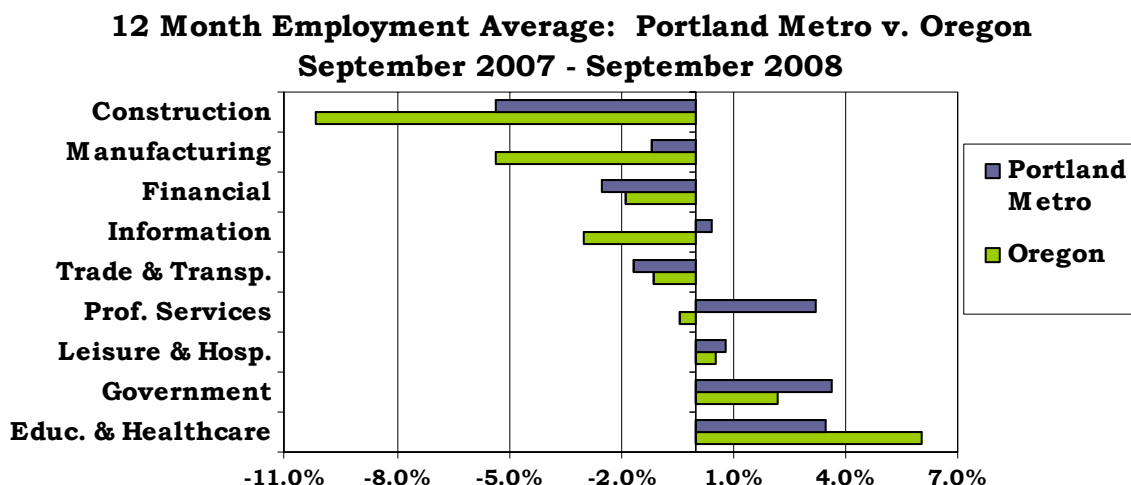
⁵ Fahey, Marge, and Krueger, Robert, "Commercial Real Estate Market to Hit Rock Bottom Next Year", Urban Land Institute,

<http://www.uli.org/sitecore/content/ULI2Home/News/MediaCenter/PressReleases/2008/2009%20Emerging%20Trends%20Report.aspx>

⁶ All employment figures from the Oregon Employment Department, unless indicated otherwise.

⁷ Cushman & Wakefield, Third Quarter 2008 Update.

came from businesses related to private-sector education, which added 6,300 jobs at the start of the school year.



Source: Oregon Employment Department

The key for Portland to manage this downturn will be to continue to hold onto what jobs we do have and to work to create additional employment. Over the last few years, the region has gathered a significant attention as a leader in sustainable and renewable energy technologies. Denmark's Vestas Wind Systems, the world's largest windmill manufacturer, has set up its North American headquarters and manufacturing facility in Portland's Rivergate District. The company already employs 300 and expects to add another 200 workers in the next few years. Another wind power company, the Spanish owned Iberdrola Renewables, Inc., has located its U.S. headquarters in the Pearl District and currently employs 375. Beyond wind technology the region is also establishing a presence as a national leader in solar technology. SolarWorld, one of the largest producers of solar cells in the world, recently opened a 480,000 square foot manufacturing facility in the dormant Komatsu plant in Hillsboro. The company plans to employ 1,000 workers by 2011.⁸

Portland also leads the way in green building, with by far the largest per capita concentration of LEED certified buildings in the country. Oregon offers a favorable environment for manufactures and users of sustainable and renewable energy through tax incentives and credits. According to Greenlight Greater Portland, a consortium of private sector leaders focused on promoting green industries, the region compares favorably on a number of different metrics. Beyond the state tax incentives, the Portland MSA has a well educated workforce, cost efficient utilities, relatively low industrial space costs in comparison to other west-coast cities, and an established presence of other related businesses. In a tough economy, looking for ways to cut expenses makes sense. Green technologies should continue to be at the forefront of new business generation.

⁸ The Portland Tribune, "SolarWorld Plant Heats Up State's 'Green' Economy", October 17, 2008.

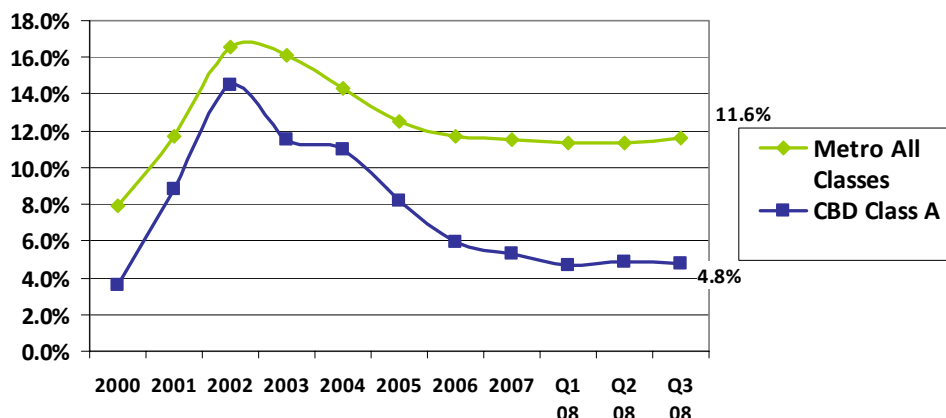
Third Quarter Office Market Trends⁹

| Office | CB Richard Ellis | Cushman & Wakefield | Grubb & Ellis | Norris, Beggs & Simpson | Median |
|--|------------------------|---------------------------|------------------|-------------------------------|----------------|
| Market-Wide Vacancy | 10.7% | 11.9% | 11.6% | 13.4% | 11.8% |
| Previous Quarter | 10.7% | 11.4% | 11.3% | 13.2% | 11.4% |
| Third Quarter 2007 | 10.9% | 11.5% | 11.7% | 13.0% | 11.6% |
| CBD and Downtown Vacancy | 7.6% | 8.5% | 7.6% | 9.0% | 8.1% |
| Previous Quarter | 7.8% | 9.1% | 7.8% | 9.8% | 8.5% |
| Third Quarter 2007 | 8.2% | 9.2% | 8.3% | 10.3% | 8.8% |
| CBD Class A | 4.6% | 5.6% | 4.8% | 5.6% | 5.2% |
| Previous Quarter | 5.3% | 6.2% | 4.9% | 6.5% | 5.8% |
| Third Quarter 2007 | 5.0% | 5.9% | 5.2% | 5.9% | 5.6% |
| CBD Class A Asking Rents | \$26.91 | \$26.61 | \$26.48 | N/A | \$26.61 |
| Previous Quarter | \$27.04 | \$26.49 | \$25.94 | N/A | \$26.49 |
| Third Quarter 2007 | \$24.17 | \$25.27 | \$25.14 | N/A | \$25.14 |
| Suburban Vacancy | 13.6% | 15.3% | 14.0% | 15.6% | 14.7% |
| Previous Quarter | 13.0% | 13.5% | 13.4% | 15.0% | 13.5% |
| Third Quarter 2007 | 13.4% | 13.7% | 13.8% | 14.9% | 13.8% |
| Suburban Class A Vacancy | N/A | 15.8% | 15.6% | N/A | 15.7% |
| Previous Quarter | N/A | 14.0% | 14.9% | N/A | 14.5% |
| Third Quarter 2007 | N/A | 13.7% | 10.5% | N/A | 12.1% |
| Suburban Class A Asking Rents | N/A | \$24.46 | \$24.11 | N/A | \$24.29 |
| Previous Quarter | N/A | \$24.47 | \$24.35 | N/A | \$24.41 |
| Third Quarter 2007 | N/A | \$23.79 | \$24.34 | N/A | \$24.07 |

⁹ Source: CB Richard Ellis (CBRE), Cushman & Wakefield, Norris, Beggs and Simpson, and Grubb & Ellis (October 2008). Vacancy rates above include subleases except those reported by CBRE. CBD figures include close-in neighborhoods, except Class A figures reported by CBRE. All rents are full service. All other suburban figures include Vancouver.

One of the two big movements in the market this past quarter was the overall vacancy, which increased 30 basis points to 11.6% over last quarter. All of this vacancy increase was attributed to additional supply in suburban markets. The median suburban vacancy rate is now 14.7%¹⁰, up noticeably from 13.5% recorded at the end of last quarter.

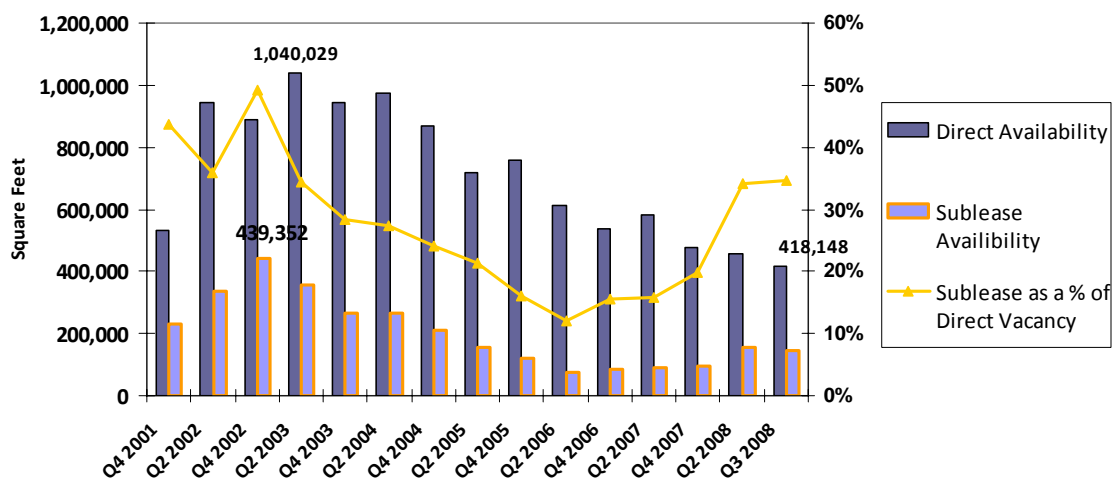
**Office Vacancy:
Metro Wide All Classes v. CBD Class A**



*Source: Grubb & Ellis, Co., Office Quarterly Report, Third Quarter 2008 Statistics

The CBD continues to perform well in terms of vacancy. At the moment, supply is relatively tight in downtown Portland, but the market will see additional office supply added in the next few quarters. Class A vacancy in the CBD is now 4.8%, but is expected to increase with the completion of four projects in the Pearl District in the next quarter, which will add over 330,000 square feet of office space to the central business district.

Office CBD Class A Direct v. Sublease Availability

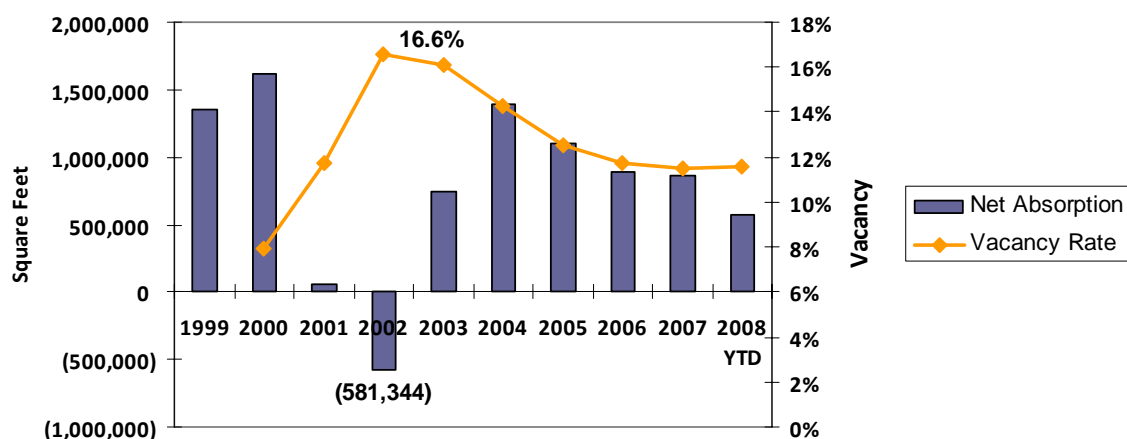


*Source: Cushman & Wakefield, Third Quarter 2008 Market Update Portland, Oregon Office & Industrial Markets

¹⁰Suburban vacancy rate based on the median of suburban vacancy rates reported by Cushman & Wakefield, Grubb & Ellis Co., NAI Norris Beggs & Simpson and CB Richard Ellis.

Based on figures compiled by Cushman Wakefield, there are approximately 418,000 square feet of Class A office space available through direct lease and another 144,000 square feet available through sublease in the CBD. Last quarter, we reported on the increase in sublease space as an indication that the downtown office market was slowing down. This quarter, however, sublease space availability managed a modest drop of 11,000 square feet, but still manages to account for over 30% of Class A space currently available. Considering the relatively tight supply of Class A space, and the lack of whole floor configurations available in the downtown market, the high percentage of sublease space is not considered a significant concern.

Overall Net Absorption (sq. ft.) and Vacancy (%) for Portland Market



*Source: Grubb & Ellis, Co., Office Quarterly Report, Third Quarter 2008 Statistics

Absorption continues to remain positive, with over 575,000 square feet absorbed in the office market so far this year. Assuming absorption continues on at this rate, the Portland office market will finish the year just shy of the ten-year average absorption level 800,000 square feet. With the current downturn in the economy and the new space coming on the market in the next quarter, it may be a struggle to end the year at this level.

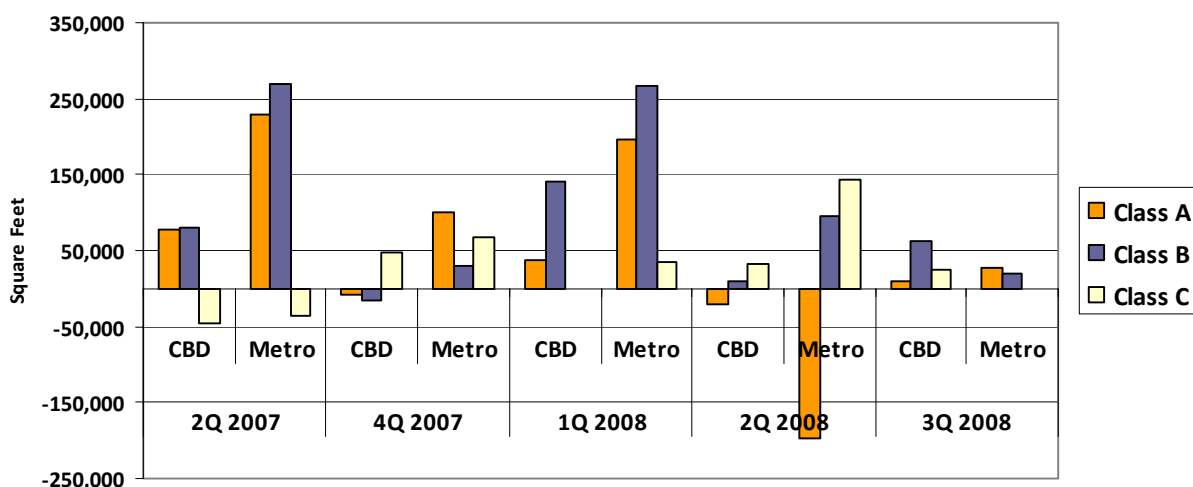
| Vacancy for Select Suburban Submarkets | | | | | |
|--|-----------------------|---------------|---------------|----------|--------------------------------|
| Submarket | Market Size (Sq. Ft.) | 2Q 08 Vacancy | 3Q 08 Vacancy | % change | Current Vacancy Square Footage |
| Kruse Way | 5,916,914 | 13.8% | 13.5% | 2.2% | 797,905 |
| Sunset Corridor | 3,721,895 | 21.2% | 22.3% | -5.2% | 829,593 |
| Beaverton | 3,484,188 | 17.2% | 16.9% | 1.7% | 589,439 |
| Eastside | 2,084,026 | 6.7% | 8.2% | -22.4% | 171,132 |
| Johns Landing/Barber Blvd. | 1,679,436 | 13.3% | 14.2% | -6.8% | 239,176 |
| Tualatin/Wilsonville | 1,600,522 | 21.9% | 28.7% | -31.1% | 460,089 |

Source: Grubb & Ellis, Co., Office Quarterly Reports, Second and Third Quarter 2008 Statistics

Suburban submarkets experiencing the largest percentage increases in vacancy over the past quarter were Tualatin/Wilsonville, the Eastside and the Sunset Corridor. The Tualatin/Wilsonville market saw the delivery of the Wilsonville Town Center, which added over 42,000 square feet of vacant space. As reported by Cushman Wakefield, the west-side markets have had continued fallout from the housing crises with the closure of commercial offices supporting that industry. The largest blocks of vacant space are currently located on Kruse Way, the Sunset Corridor and Beaverton, where there is anywhere between 580,000 and 829,000 square feet of available space.

The total third quarter 2008 absorption for the entire metro office market was weak at only 48,000 square feet. This was barely noticeable from the second quarter of 2008, which recorded a gain of only 42,000 square feet. The difference this quarter is that most of the negative absorption was recorded in Class C space, as opposed to the negative absorption of Class A space in the second quarter. Considering the challenging economic times, it is encouraging that absorption is still positive, but the decline in leasing activity is apparent.

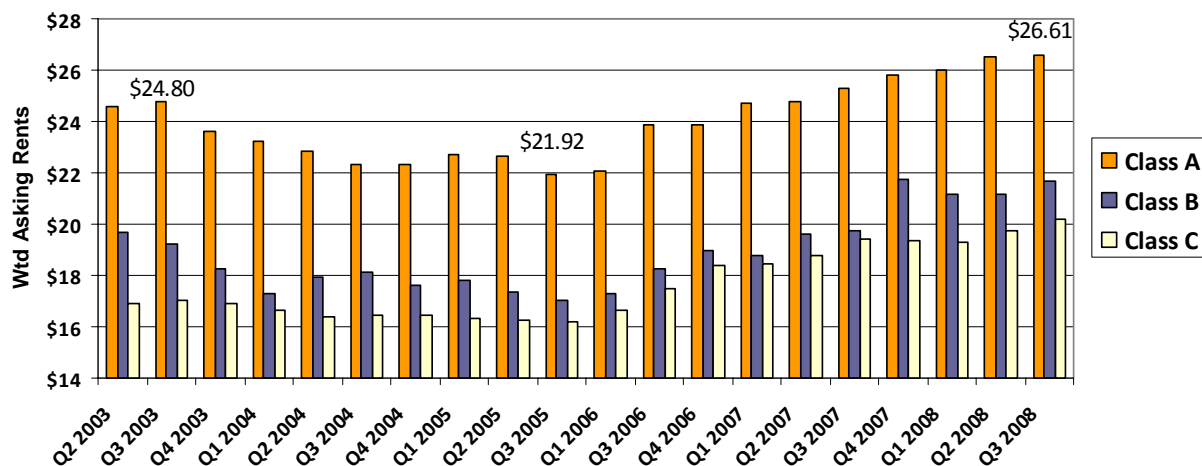
Office Absorption for Class A, B & C



*Source: Grubb & Ellis, Co., Office Quarterly Report, Second and Third Quarter 2008 Statistics

Rental rates in the CBD continue to climb, with the Class A asking rate now at \$26.61 per square foot, according to Cushman & Wakefield's most recent survey. Since the first quarter of 2006, Class A asking rents in the CBD have increased by \$4.57, or over 20%. Similar percentage increases have also occurred in the Class B and C office space markets. CB Richard Ellis reports that suburban asking rents continue to climb as well, which is a reflection of the new construction that has been added. According to CB Richard Ellis, suburban rents in 2008 have increased 6.8% and now average \$21.46 a square foot.

CBD Direct Rental Asking Rates/sq.ft.



*Source: Cushman & Wakefield, Third Quarter 2008 Market Update Portland, Oregon Office & Industrial Markets

The following is a list of significant new construction projects occurring downtown. By the close of 2008, over 330,000 square feet of space will be added to the Pearl District and another 203,000 square feet will be added in 2009. The addition of this new space represents an increase of approximately 5.3% to the current CBD Class A supply.

CBD New Construction

| Building | Owner | Location | CBD Area | Sq. Ft. | Completion Date |
|--------------------------|-------------------|-------------------|-------------|------------------|-----------------|
| The Lovejoy | Unico | NW Lovejoy & 13th | Pearl | 82,843 | 4qtr 08 |
| East of Pearl | JBH Co. | 321 NW Glisan | Pearl | 87,876 | 4qtr 08 |
| Machine Works | Machine Works LLC | 1455 NW Northrup | Pearl | 112,000 | 4qtr 08 |
| 809 NW Flanders | ConOverBar | 809 NW Flanders | Pearl | 48,000 | 4qtr 08 |
| bside6 | Lance Marrs | 534 E. Burnside | Close-In SE | 23,310 | 1qtr09 |
| Ziba Design Headquarters | Ziba | 1044 NW 9th Ave. | Pearl | 70,000 | 2qtr 09 |
| ZGF Building | Gerding Edlen | 431 SW 12th Ave. | N. downtown | 110,000 | 2qtr 09 |
| Meier & Frank Building | Gerding Edlen | 1417 NW Everett | Pearl | 92,816 | 1qtr 10 |
| First & Main | Equity Office | 100 SW Main St. | Downtown | 366,500 | 1qtr 10 |
| Park Ave West | TMT Dev. | 700 SW 9th Ave. | Downtown | 330,000 | 1qtr 11 |
| Total | | | | 1,323,345 | |

CBD Office Construction in the Pearl District & North Downtown¹¹



Machine Works

1455 NW Northrup
112,000 sq. ft.
\$34 FSG



The Lovejoy

NW Lovejoy & 13th Ave.
82,843 sq. ft.
\$33.50 FSG



Liba Design HQ

1044 NW 9th Ave.
70,000
Owner Occup.



East of Pearl

321 NW Glisan
87,976 sq. ft.
\$29.00 FSG



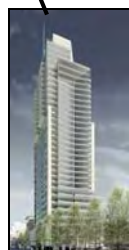
14th & Everett

(Meier & Frank)
1417 NW Everett
92,816 sq. ft.
\$26.00 NNN



12th & Washington

431 SW 12th Ave.
110,000 sq. ft.
Asking Rent N/A



Park Ave. West

700 SW 9th Ave.
330,000 sq. ft.
\$25-\$28 NNN

bside6

534 E. Burnside
23,310
Asking Rent N/A



First & Main

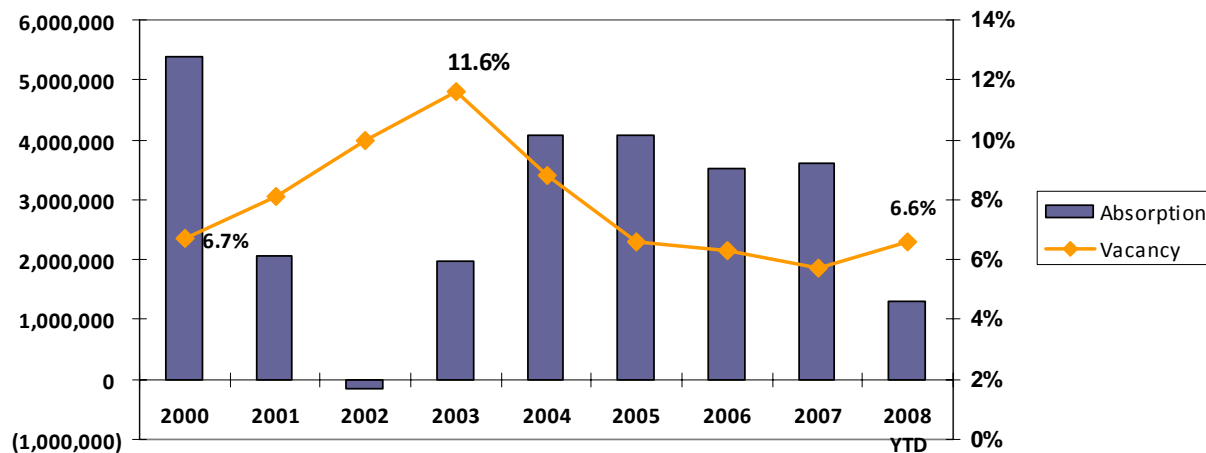
100 SW Main
366,500 sq. ft.
\$35.00 FSG

¹¹ Asking Rent information from Grubb & Ellis Co. Portland Office Report, 3rd Quarter 2008

Industrial Market

Signs of the slowing economy are more apparent in the industrial market. The sector depends heavily on employment, and the timelines to construct new space are much shorter than other types of development. With unemployment trending up, new industrial construction has been substantially scaled back. Industrial vacancy has increased 30 basis points over last quarter and now registers 6.6%.¹² Absorption has also turned negative, which has not occurred since the third quarter of 2003, according to CB Richard Ellis.

Overall Industrial Net Absorption (sq. ft.) and Vacancy (%) for Portland Market

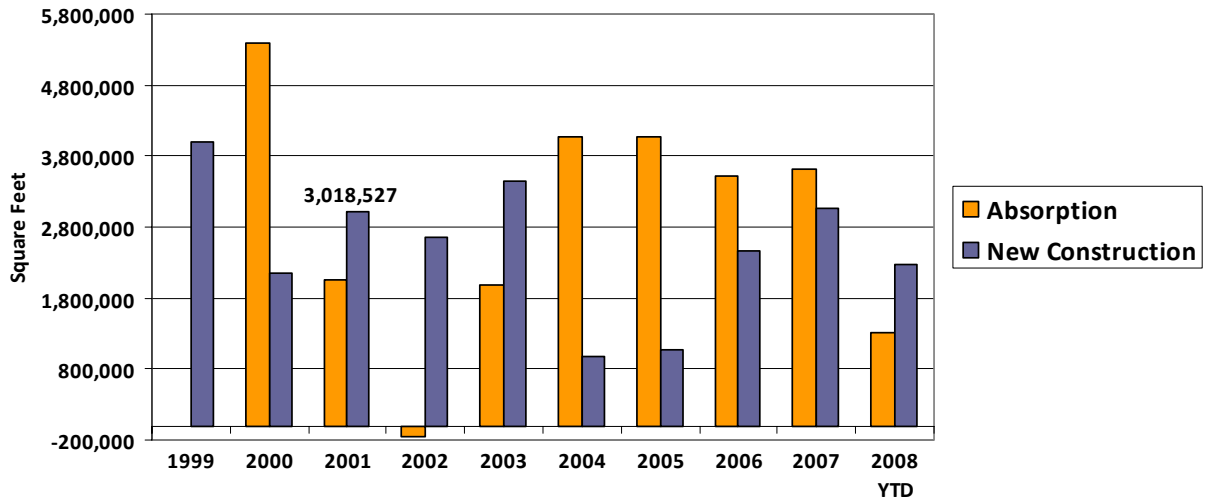


Source: Grubb & Ellis Co., Industrial Quarterly Report, Third Quarter 2008.

After four years of decreased vacancy, the industrial vacancy rate is starting to trend upwards. Absorption figures for the third quarter vary between the four local brokerage houses, with a range of a negative <456,000> square feet from Cushman Wakefield to a positive 248,000 square feet from NAI Norris Beggs Simpson. Regardless of this variability, all local brokers report that leasing activity has dropped significantly. Based on figures from Grubb & Ellis Co., year to date absorption stands at 1.3 million square feet and will fall short of the 3.8 million square feet of yearly absorption enjoyed during the previous four years.

¹² Based on a median average of vacancy reported by Cushman & Wakefield, Grubb & Ellis Co. and CB Richard Ellis.

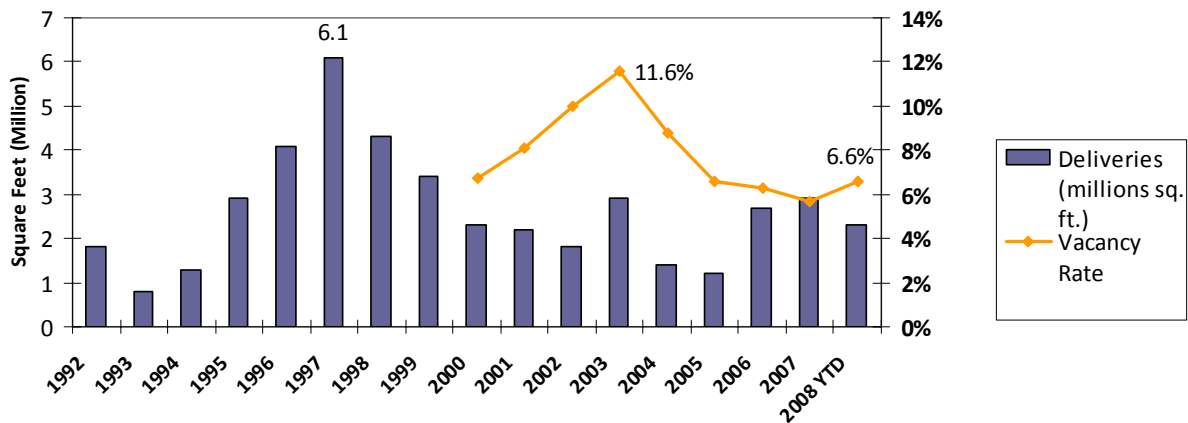
Industrial Absorption and New Construction (Sq. Ft.)



*Source: Grubb & Ellis Co., Industrial Quarterly Report, Third Quarter 2008.

Absorption for the years 2004 through 2007 outpaced new construction. That trend will most likely come to an end this year due to the addition of nearly 2.3 million square feet of new industrial space added so far this year. At this time, there are approximately 698,000 square feet of industrial space under construction and will be delivered to the market by the end of the first quarter 2009. Since all but 60,689 square feet of this space is speculative, absent any economic turnaround, vacancy rates will most certainly be on the rise.

Historical Industrial Deliveries (sq. ft.) and Vacancy (%) for Portland Market



*Source: Grubb & Ellis Co., Industrial Quarterly Report, Third Quarter 2008, and The CoStar Industrial Report, Portland Market, Mid-Year 2008

Third Quarter Industrial Market Trends¹³

| | CB Richard Ellis | Cushman & Wakefield | Grubb & Ellis | Median |
|---------------------------------------|-----------------------------|------------------------------------|------------------------------|---------------|
| Market-wide Vacancy | 6.1% | 6.7% | 6.6% | 6.6% |
| Previous Quarter | 5.8% | 6.3% | 6.7% | 6.3% |
| Third Quarter 2007 | 4.9% | 5.0% | 5.3% | 5.0% |
| Warehouse/Distribution | N/A | 5.8% | 6.7% | 6.3% |
| Previous Quarter | N/A | 5.8% | 6.8% | 6.3% |
| Third Quarter 2007 | N/A | 4.3% | 4.8% | 4.6% |
| R&D/Flex Vacancy | N/A | 9.5% | 6.3% | 7.9% |
| Previous Quarter | N/A | 9.2% | 6.5% | 7.9% |
| Third Quarter 2007 | N/A | 9.2% | 7.0% | 8.1% |
| Asking Monthly Shell Rates | \$0.39 | N/A | \$0.42 | \$0.41 |
| Previous Quarter | \$0.39 | N/A | \$0.42 | \$0.41 |
| Third Quarter 2007 | \$0.37 | N/A | \$0.41 | \$0.39 |
| Asking Monthly Flex Rates | \$0.85 to \$1.05 | N/A | \$0.85 | N/A |
| Previous Quarter | \$0.85 to \$1.05 | N/A | \$0.82 | N/A |
| Third Quarter 2007 | \$0.85 to \$1.05 | N/A | \$0.83 | N/A |

Major Lease Transactions

| Tenant | Building | (Sq. Ft.) | Submarket |
|------------------------------|-------------------------------------|------------------|------------------|
| Odom Corp. | Cascade Distribution Center | 150,615 | North/Northeast |
| Fidelity National Title | Kelly Point Distribution Center | 100,750 | Rivergate |
| MacSteel Service Centers | 4033 NW Yeon Ave. | 89,418 | Northwest |
| CRT Processing | 10151 SE Jennifer Street | 75,196 | Southeast |
| Fulfillment Corp. of America | 217 Distribution Center, Building C | 66,950 | Beaverton |
| Fluid Connector Products | 2929 NW 31st Ave. | 36,138 | Northwest |
| Cascade Controls Northwest | Rockwood Corp. Center | 29,250 | Gresham |

**Source: NAI Norris Beggs & Simpson, CB Richard Ellis, and Cushman & Wakefield, Industrial Quarterly Reports, Third Quarter 2008, and the Portland Business Journal*

¹³ *Source: CB Richard Ellis, Cushman & Wakefield, and Grubb & Ellis (Third Quarter 2008). Warehouse and Distribution figures for Cushman & Wakefield include manufacturing space which represents one-fifth of warehouse/distribution space. All rents are NNN.